

DOCUMENT RESUME

ED 153 512

EE 009 642

TITLE A Guide to Tax Policy and Higher Education. A
Looseleaf Reference Service on Tax Issues Affecting
Higher Education.

INSTITUTION American Council on Education, Washington, D.C.;
Association of Governing Boards of Universities and
Colleges, Washington, D.C.; Council for Advancement
and Support of Education, Washington, D.C.; National
Association of Independent Colleges and Universities,
Washington, D.C.

PUB DATE Feb 78

NOTE 61p.

AVAILABLE FROM Office of Research, National Association of
Independent Colleges and Universities, 1717
Massachusetts Avenue N.W., Washington, D.C. 20036
(\$1.00)

EDRS PRICE MF-\$0.83 HC-\$3.50 Plus Postage.

DESCRIPTORS Administrator Guides; Chief Administrators;
*Educational Finance; *Government School
Relationship; *Higher Education; Institutional
Administration; Legislative; Presidents; Public
Policy; *Taxes; Trustees

ABSTRACT

The guide is intended to help presidents, trustees,
and friends of higher education understand and act upon the many
issues of tax policy that will affect their institutions. The
contents include: (1) an introduction to the purpose, organization,
and uses of the reference; (2) a paper on the principal tax issues
affecting higher education most likely to arise during 1978-79 or
during consideration of comprehensive tax legislation; and (3) a list
of selected readings. (MSE)

* Reproductions supplied by EDRS are the best that can be made *
* from the original document. *

1/30/78

A GUIDE to TAX POLICY and HIGHER EDUCATION

A Looseleaf Reference Service

on

Tax Issues Affecting Higher Education

February 1978

U.S. DEPARTMENT OF HEALTH
EDUCATION & WELFARE
NATIONAL INSTITUTE OF
EDUCATION

THIS DOCUMENT HAS BEEN REPRODUCED EXACTLY AS RECEIVED FROM THE PERSON OR ORGANIZATION ORIGIN. AT SEVERAL POINTS OF VIEW OR OPINIONS STATED DO NOT NECESSARILY REPRESENT OFFICIAL NATIONAL INSTITUTE OF EDUCATION POSITION OR POLICY.

Prepared By

The National Association of Independent Colleges and Universities

in cooperation with

The American Council on Education

The Association of Governing Boards

The Council for Advancement and Support of Education

Publication Notes

The Ohio Board of Regents is providing copies of this publication to all trustees of public and independent colleges and universities in the State of Ohio.

NAICU wishes to acknowledge with grateful appreciation the support and assistance received from the Association of American Universities and the Association of Jesuit Colleges and Universities, in addition to that of the three primary co-sponsoring associations, in the development of this publication.

©1978, by

National Association of Independent Colleges and Universities

Additional copies may be obtained for \$1.00 from the

Office of Research
NAICU

1717 Massachusetts Avenue, N.W., #503
Washington, D.C. 20036

2-A

A GUIDE to TAX POLICY and HIGHER EDUCATION

CONTENTS

- A. Introduction to A Guide to Tax Policy and Higher Education
- B. Some Basic Tax Issues of Interest to Higher Education
- C. Selected Readings in Taxation and Higher Education
- D. Tax Studies -- A Continuing Series of Papers on Specific Tax Issues Affecting Higher Education

Works in Progress, January, 1978:

- 1. Background on the Theory and Practice of Federal Taxation and the Charitable Deduction
- 2. The Case for the Charitable Deduction: History, Philosophy and Effect
- 3. The Case for the Charitable Deduction: A Deduction, Not a Credit
- 4. The Case for the Charitable Deduction: No Qualifying Floor
- 5. The Case for the Charitable Deduction: Extending Eligibility to Every Taxpayer
- 6. The Case for the Charitable Deduction: Full Fair Market Value Deductibility for Gifts of Appreciated Property
- 7. The Case for Scholarships and Related Awards: Exclusion from Income Taxation

INTRODUCTION

to

A GUIDE to TAX POLICY and HIGHER EDUCATION

Purpose	.2
Spectrum of Tax Issues.	.2
Initial Focus	.6
Role of Presidents, Trustees and Friends.	.7
Organization.	.7
Contents.	.8
Uses.	.9

INTRODUCTION
to
A GUIDE to TAX POLICY and HIGHER EDUCATION

Purpose

A Guide to Tax Policy and Higher Education is intended to help presidents, trustees, and friends of higher education understand and act upon the many issues of tax policy that will affect their institutions.

Spectrum of Tax Issues

The list of tax issues affecting higher education is practically inexhaustible. Federal, state and local governments constantly scrutinize their tax laws to determine whether these are serving broad, publicly accepted purposes, and whether these could be made to produce greater revenues.

At the federal level, pressures have mounted over the last two decades for a comprehensive revision of federal tax policy and practice. Both the federal individual income tax and estate tax are being studied to determine if they are consistent with tax theory and if they serve efficiently and fairly the public purposes for which they were enacted.

Two provisions of extraordinary interest to higher education that have drawn considerable attention from tax experts in government, universities, research centers, the press, the legal community, and organized citizens groups are the individual income tax charitable deduction and the estate tax charitable deduction. The individual income tax basically allows a taxpayer who itemizes personal deductions to take a deduction for his gifts to public charities. He is, however, limited overall in any year to a deduction equal to 50 percent of his adjusted gross income, and is further limited to a deduction of 30 percent of adjusted gross income for gifts of property whose market value has increased over its value at the time of acquisition by the taxpayer, and which would produce capital gains income if sold (appreciated property). There are many technical rules, definitions and interrelationships that complicate this seemingly simple basic description. It is enough to point out that this basic provision, with all its complex detail, has been the subject of much controversy and criticism over the past decade.

Professor Stanley S. Surrey of Harvard Law School, who served as Assistant Secretary of the Treasury for Tax Policy under Presidents Kennedy and Johnson, published two seminal law review articles in

1970.¹ They were based in part on a comprehensive study of the federal tax laws he had authored while at the Treasury. They raised serious questions about the charitable deduction and other exclusions, exemptions and deductions in the Internal Revenue Code. While others had previously made similar points about individual parts of the personal income tax,² Professor Surrey's articles provided a sophisticated conceptual framework for examining all of its provisions and evaluating them by common standards.

The key elements of this framework were the concepts of "tax expenditures" and the "Tax Expenditure Budget".³ They were first introduced by him in a speech in late 1967 discussing the budgetary dilemmas confronting the Johnson Administration.⁴ He noted that Congress and the Administration were only examining the federal programs financed directly by Congressionally authorized expenditures, but not those financed, indirectly in his view, through Congressionally enacted provisions in the federal individual income tax system. To remedy this, he recommended categorizing the latter kind of "spending" programs, "tax expenditures", and creating an annual "Tax Expenditure Budget" to show the impact of these on public policy. The first was published by the Department of the Treasury in January, 1968.

Oversimplifying, the tax expenditure concept is developed as follows. The ability to pay is deemed to be the proper basis for personal taxation. Net income is the best approximate measure of ability to pay according to the dominant theory of individual income taxation.⁵ Certain deductions from gross income are essential to the calculation of net income. They are called income-defining deductions. Such deductions are considered to be an inherent part of the structure of an ideal income tax system. In general, under this theory, expenditures necessary for the earning or production of income are the only income-defining deductions. Any other deductions are non-income-defining and represent a departure from the ideal standard. They must be justified, if at all, by some other rationale than that of tax theory.⁶ According to Professor Surrey and other tax theorists generally in agreement with him, the non-defining deductions are classified as "tax expenditures". Because of each of these, the federal government collects less revenue than it would if the tax system allowed only theoretically essential deductions (or other adjustments to income). This lost or foregone revenue is, according to this concept, in effect "spent" through the tax system to accomplish certain public objectives, such as home ownership (home mortgage interest and real estate tax deduction), capital investment (accelerated depreciation and capital gains), and philanthropy (charitable deduction). He concluded that this tax "spending" should be periodically evaluated just as are, allegedly, those governmental programs for which Congress directly authorizes expenditures. Those "nonessential" tax deductions that prove to be effective, efficient and fair in accomplishing public objectives, compared to direct spending alternatives, might be retained in the tax law, but he doubted that many would upon analysis prove to be so justified. Otherwise, he argued that they should be repealed.

Of course, there are several major assumptions underlying these concepts, and there is disagreement over both the scope and validity of this conceptualization of the federal individual income tax system.⁷ But, for the moment, as reference points to public policy, these disagreements are almost purely academic. The tax expenditure concept has, at least for now, center stage and defines the terms of the debate.

These concepts were first used effectively in the debates leading to passage of the 1969 Tax Reform Act, which placed some significant limitations upon the charitable deduction. Since then, they have been firmly institutionalized into the federal governmental budget and tax processes by the enactment of the Congressional Budget and Impoundment Control Act of 1974,⁸ by the annual publication of a "Tax Expenditure Budget" by the Treasury Department, and by their general use in public discussions of issues in federal income taxation. In reality, Professor Surrey and other proponents of these concepts⁹ have set the agenda and provided the vocabulary for the debate on federal tax policy that has been underway since 1969. And, on that agenda, the charitable deduction is listed as an exception to or departure from the "normal" or ideal structure of the tax law.¹⁰

The scholarship of Professor Surrey and others was not the only factor directing public attention to the myriad provisions in the income tax. There was also a dramatic political factor. In January, 1969, just before leaving office, Secretary of the Treasury, Joseph W. Barr, announced that several hundred taxpayers with incomes in excess of \$100,000 per year were paying no or almost no taxes. He attributed this fact to their widespread use of various legitimate deductions, exemptions, exclusions, and reduced rates in the tax law such as special treatment of capital gains income, home mortgage and other interest expense deductions, medical expense deductions, and the charitable deduction. This, too, had a major impact on the debate over the 1969 tax reform legislation. Each year since 1969, a similar announcement¹¹ has been published by the Treasury Department, keeping public attention drawn to the detailed provisions of the tax code.

These two factors, one conceptual and one political, continue to dominate discussion of the income tax system. The charitable deduction is a conspicuous item on that comprehensive tax agenda. The 1969 Tax Reform Act placed some significant limitations on certain kinds of charitable giving. During the Congressional consideration of that bill, the charitable community barely defeated proposals of even greater consequence for private philanthropy. Since then, no truly direct attack on the deduction has succeeded.

But it is not only the direct challenges to the charitable deduction that can affect seriously charitable giving. Even where the focus is on other parts of the tax code seemingly unrelated to the charitable deduction, there can be harmful consequences for philanthropy. For example, last summer, the Secretary of the Treasury included in a late draft of tax proposals for possible consideration by the President recommendations for sweeping changes in the laws governing the sale or

exchange of so-called long term capital gains property. Had such changes been proposed, depending on the exact language of the legislation, they could have posed a severe threat to charitable giving. According to one econometric analysis of such a proposal, based on 1970 data, the potential cost in donations to all of education would have been eight percent of annual giving.¹²

An even more dramatic example is found in the so-called standard deduction.¹³ This is the provision in tax law that allows a taxpayer to deduct a flat dollar amount rather than itemizing personal deductions such as home mortgage interest payments, property, sales and gasoline tax expenses, casualty losses, medical expenses and charitable gifts. In 1970, despite the burdensome calculations and record-keeping, 50 percent of all taxpayers itemized their deductions rather than taking the standard deduction because this choice meant lower taxes for them. Since 1970, there have been five increases in the standard deduction. As a result, only 25 percent of all taxpayers today itemize their deductions. For the other 75 percent, taking the standard deduction means lower taxes than is possible by itemizing. Under President Carter's recent tax proposals, only 16 percent of all taxpayers would have any incentive to itemize deductions; 84 percent would take the standard deduction.¹⁴

What does this have to do with the charitable deduction? Quite simply, taxpayers who use the standard deduction cannot take the charitable deduction. They have, therefore, less incentive to make charitable contributions. There is no longer for them any public recognition given to the truly public character of their voluntary private gifts to institutions which serve the common goals of the community. As a result, they give less than they would have had they itemized their deductions.

This indirect effect on charitable giving of the increasing proportion of taxpayers taking the standard deduction has been measured; its magnitude is extraordinary. Recent studies¹⁵ have estimated that charities have lost about \$5 billion in gifts from 1970-1976 because of increased use of the standard deduction. These same studies estimate that this factor will have caused an additional loss of another \$1.357 billion in annual charitable giving in 1977.

These immediate losses in annual giving, however, are the least of the harmful consequences of this trend. Over the longer run, younger alumni and alumnae, who will increasingly tend to use the standard deduction, will be less likely to develop early the habit of annual giving. The effect of this on annual giving will not be noticeable for a decade or more; by then, it will be too late. Of equal concern, as ever smaller numbers of taxpayers itemize, the universal character of charitable giving will be lost and the deduction will become politically vulnerable. As only the very well-to-do continue to itemize, the charitable deduction will appear to lose its unique status as the one deduction in the code that is given not for spending income on oneself, but for sharing it with the whole community. While leaders

of higher education cannot and should not oppose increases in the standard deduction, they should be searching for and advocating ways to offset the negative effects these increases have on charitable giving.¹⁶

Similar criticisms and problems arise in connection with the estate tax charitable deduction. Basically, in determining the value of the estate that will be subject to taxation, the law allows an unlimited deduction for bequests to charity. While, as in the case of the individual income tax charitable deduction, there are complicating details, this basic characteristic of the estate tax is central to this GUIDE. The critics of the estate tax charitable deduction often focus on its unlimited character, especially in contrast to its income tax counterpart, as well as on its alleged interference with the estate tax' revenue potential and that tax' purpose to discourage intergenerational transfers within the same family of the control over or the ownership or use of property.

In addition to such direct questions about this deduction, indirect problems also arise at the boundary between income taxation and estate taxation. This is especially so with respect to periodic proposals for the taxation of the appreciation (basically, the difference between current market value and the value at the time the property was acquired by the taxpayer) in property in the estate at the time of death, either through the income tax or through an added provision in the estate tax.

While the estate tax charitable deduction has not been as publicly a target of the "tax expenditure" school of tax theory as has the income tax provision, it has, nonetheless, been a target of critics of the estate tax system. The importance of this deduction to higher education, however, cannot be overstated. One estimate is that placing a 50 percent limit on the deductibility of charitable bequests would cost charities \$4.40 in gifts for every \$1.00 in added revenue for the government.¹⁷

Initial Focus

It is obvious that higher education has a crucial interest in the debate over the federal tax system. But the direct and indirect threats to charitable giving are not the only federal tax issues that will affect higher education. Among others are:

- (a) the exemption of charities from income taxation;
- (b) the integration of the corporate and individual income taxes;
- (c) the withholding of taxes against dividend income;
- (d) the unrelated business income tax;
- (e) the social security and other payroll taxes;

- (f) the exclusion from taxation of scholarships, fellowships and related awards; and
- (g) the dependency deduction for children over age 18 attending colleges or universities.

Finally, there are serious tax issues affecting higher education at the state and local levels. Such issues as exemptions from state income and sales taxes and from local property taxes are on the agendas of many state and local governments.

Because of their wide and immediate importance, the GUIDE will first be focussed upon issues affecting higher education arising from federal individual income and federal estate taxation. Initial attention will be given to issues involving the charitable deduction and scholarships, fellowships and employer-sponsored employee educational programs.

Role of Presidents, Trustees and Friends

Many educational leaders may not be fully aware of the direct or indirect effects of proposed tax legislation on, for example, charitable giving, or of the alternatives to such tax proposals that would eliminate or lessen any negative impact on philanthropy. Trustees, on the other hand, some of whom may be more generally familiar with the complexities and interactions of tax law, may not always be aware of the full consequences of certain tax policies for non-profit institutions. That tax issues are usually relegated to experts, who often write and speak only to other experts, only compounds these difficulties. Past experience, at least since 1969, makes it clear that tax policy is too important to be left only to experts. Educational leaders now must be well-informed students of major tax issues and persuasive advocates for the tax policies that enable their institutions to accomplish the public purposes entrusted to them. To this end, presidents, trustees and friends need succinct and timely information on proposed tax legislation so that they may determine by debate and discussion the tax proposals that will best serve the public goals of higher education. Such discussion will help them develop coherent positions on tax bills and a basis for informing members of the Congress and the Administration of the impact of a given tax policy upon their own institutions, and in concert with other philanthropic leaders, of its effect upon the whole community.

Organization

This GUIDE is designed to serve as a current reference to the tax issues affecting higher education and private philanthropy. It is organized in loose-leaf style, for filing in a three-ringed notebook, so that amended, up-dated, or new information can be easily incorporated. This format will also allow individual users to add to their

GUIDE such items as legislative status bulletins, memoranda of discussions with relevant governmental officials, other readings on tax policy, and compilations of local statistics and anecdotes on the economic and social contribution of higher educational and other philanthropic institutions to their local communities, congressional districts, or states.

Contents

This GUIDE will offer precise identification and thorough analysis of tax policy issues confronting higher education in a concise and timely manner. It will contain:

- (a) This introductory paper, "Introduction to A Guide to Tax Policy and Higher Education," to explain the purpose, organization and uses of this reference service.
- (b) A paper, "Some Basic Tax Issues of Interest to Higher Education," listing the principal tax issues affecting higher education which are most likely to arise during 1978-79 or during consideration of comprehensive tax legislation. There will be periodic supplements to this paper as additional issues arise.
- (c) A listing, "Selected Readings on Taxation and Higher Education," several basic references on tax theory and tax issues affecting higher education for those who wish to read more deeply. There will be periodic supplements to this list.
- (d) A paper, "Background on the Theory and Practice of Federal Taxation and the Charitable Deduction," to show how the charitable deduction fits into the overall federal tax system, to explain the questions raised by some of the critics of the charitable deduction, and to list some of the responses to these criticisms.
- (e) The papers, "Tax Studies," a continuing series of concise and timely reports on each of the specific tax issues affecting higher education that may arise in the tax legislature process. These will include reports on each of the subjects in the paper, "Some Basic Tax Issues of Interest to Higher Education." Each report will present a statement of the issue, an analysis of its impact on higher education, a summary of the theoretical and policy arguments for and against the issue, a presentation of any empirical evidence about the issue, and a summary of any alternative policies that might be pursued.
- (f) Briefing documents, two-page summaries of each of the major issues covered by the "Tax Studies," designed to assist public discussion about specific tax proposals.

Uses

Leaders of higher education and other charities in each community and region can enhance the persuasiveness and usefulness of these studies by the addition of local statistics and anecdotes. These studies should serve as a foundation for marshalling local data to document the importance to higher education and the local public well-being of charitable giving. For example, local philanthropic leaders might add to a basic study the following kinds of information: (1) an accounting of the amount of charitable giving to local institutions; (2) a listing of the range of activities and persons helped by such gifts; (3) a listing of large gifts, particularly of appreciated property, and of specific major activities in small and large institutions made possible by them; (4) a cataloguing of anecdotes about specific gifts and the activities supported; and (5) an accounting of the economic benefits conferred on the local area by institutions of higher education and other charitable organizations.¹⁸

Anecdotes are critical. Anecdotes put life into numbers and give legislators, administrators and the public at large concrete reasons to recognize the importance to the existence and quality of higher education and the vitality of their communities of the present income and estate tax treatment of charitable giving.

If a college's board of trustees has not already created a small subcommittee on taxation it might wish to consider doing so.

Its files could become the repository of the data and anecdotal information just described; its members could be given first responsibility for developing the college's position on proposed tax legislation; they could, either formally or informally, associate themselves with similarly tax-conscious trustees of other charitable institutions in the community, and throughout the congressional district or state; and they could become the highly knowledgeable and effective spokesmen for the college's, and other charities', position on tax matters in a wide variety of forums.

The formation of such well-integrated networks of informed trustees, and other friends of philanthropy, across all the states and the majority of congressional districts, can go far toward insuring the charitable community against the potentially enormous losses that the next round of major tax legislation could produce.

NOTES

- ¹Surrey, "Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures," 83 Harvard Law Review 705 (1970); and Surrey, "Federal Income Tax Reforms: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Government Assistance," 84 Harvard Law Review 352 (1970).

For earlier discussions, of the "comprehensive income tax base" and "tax expenditure budget" concepts see generally: Bittker, Galven, Musgrave and Pechman, A Comprehensive Income Tax Base? A Debate (1968); Aaron, "What is a Comprehensive Tax Base Anyway?," 22 National Tax Journal 543 (1969); Bittker, "Accounting for Federal 'Tax Subsidies' in the National Budget," 22 National Tax Journal 224 (1969); Surrey and Hellmuth, "The Tax Expenditure Budget - Response to Professor Bittker," 22 National Tax Journal 528 (1969); Bittker, "The Tax Expenditure Budget - A Reply to Professors Surrey and Hellmuth," 22 National Tax Journal 538 (1969).

- ²See partial listing in note 1, supra. See also, for a popularization of many of the points made in these and other studies, Stern, The Great Treasury Raid (1965); and Stern, "Uncle Sam's Welfare Program - For the Rich," New York Times, April 16, 1972, (Magazine) at 28.

- ³For a more detailed discussion of these concepts, see Surrey, Pathways to Tax Reform (1973); and the references in n. 1, supra.

- ⁴Surrey, *ibid.*, pp. vii, 3-4.

- ⁵See H. Simons, Personal Income Taxation (1938), for the initial elaboration of the theory of personal income taxation upon which the concept of "tax expenditures" is based.

- ⁶This is indeed greatly oversimplified. As Surrey explains in Pathways, *op.cit.* at 17:

The building of an income tax requires two types of provisions that collectively perform the following two functions. First, they provide the answers to those aspects of (questions about a normative model for an income tax structure) that would essentially be treated in much the same way by any group of tax experts building the structure of an income tax and being governed in that task by all the requirements implicit in such a tax because it is an income tax. These answers then become the structural provisions which shape a normative income tax. As an illustration, in this first category fall matters relating to the measurement of net income and the time periods for inclusion of that income.

In every particular personal income tax law, there are also some adjustments to income (deductions, exclusions, exemptions) that are not truly part of a normative income tax, but which, although not theoretically "income-defining,"

do become structural parts of an income tax -- and essential to the operation of that tax -- and therefore are not tax expenditures. For example, as Treasury analysis indicates, the treatment of the family e.g., the tax burden on married couples in relation to single persons -- is not part of a normative income tax. There is no preordained method of treatment that follows from the decision to adopt an income tax. Countries properly differ in the treatment depending on their attitudes toward marriage or women in the labor force and other such social and economic questions. The levels of personal exemptions and tax rates, and the degree of rate progressivity, are other examples mentioned in the treasury analysis that would fall in this second category. The treatment of the corporation -- as a separate entity or its income integrated with that of the shareholders in some fashion -- is still another example. The provisions incorporating the decisions in these areas are not tax expenditures. But the decisions have to be made before the structure of the income tax is complete and the tax is ready to be applied. As a consequence, this set of provisions, while necessary to the construction of an income tax is shaped by processes different in character from the processes determining the provisions in the first category, also relating to the inherent structure of an income tax. The tax expenditure provisions are, then, the provisions that may be found in an income tax law but that do not serve the two functions set forth above. (Surrey, Pathways, at 17-18).

⁷See generally Bittker, Galvin, Musgrave and Pechman, A Comprehensive Income Tax Base? A Debate (1968); and the other readings listed in n.l., supra. For example, Professor Bittker disagrees that there exists a sufficiently elaborated and specified theory to serve well as the foundation for an ideal or normative income tax. He would tend to view the federal personal income tax system as "an assemblage of value judgments on scores of issues that could plausibly have been decided differently. To bestow the label 'correct' on any of these human creations is to misuse the term." Bittker, "The Tax Expenditure Budget - A Reply to Professors Surrey and Hellmuth," 22 National Tax Journal 538, 542 (1969). See also, Andrews, "Personal Deductions in an Ideal Income Tax," 86 Harvard Law Review 309 (1972); and Andrews, "A Consumption-Type or Cash Flow Personal Income Tax," 87 Harvard Law Review 1113 (1974) for additional discussions of the theoretical and practical strengths and weaknesses of the use of normative models for analyzing personal income tax systems, and for a particular reference to the ordinary charitable deduction, but not the deduction for appreciated property to the extent the appreciation is never reported as gross income, as conceptually

an income-defining deduction. Finally, see Levi, "Financing Education and the Effect of the Tax Laws," 39 Law and Contemporary Problems: Federal Taxation and Charitable Organization 75 (Autumn 1975); and Kristol, "Taxes, Poverty and Equality," 37 Public Interest 3 (Fall, 1974) for critical analyses of the philosophy of the "tax expenditures" or "tax subsidy" concept:

The implicit assumption in the concept of "tax expenditures" that citizens owe their incomes to the United States, is reminiscent of the assumptions upon which feudal societies were organized. Consider, for example, how Harry A. Bigelow described the system of land holding in England during the time of Henry II.

It may, roughly, be compared to a pyramid: At the summit the pyramid was the king, who was, in legal theory, the owner of all land in England. Immediately under him were the great lords in the kingdom, holding the large tracts of land in the manner already mentioned. These tenants immediately under the king later received the name of "tenants in capite." Under the tenants in capite were various grades of intermediate or mesne tenants, and at the bottom of the pyramid may be said to be the tenants who were in actual occupation of the land, either personally or by their servants.... Thus it may be said that, except for the highest and lowest grades, each person occupied a double relation. With respect to the person under whom he was holding he was a tenant, owing fealty and faith and feudal services, and entitled to receive protection from his lord. (Levi, at 78, citing H. Bigelow, Cases and Materials in Rights in Land 2,3, (3rd edition 1945))

and

Many economists and tax experts -- Stanley Surrey, most notably -- nevertheless do favor subsidies rather than tax incentives, and argue persuasively for them.

But in the course of making these arguments, a very interesting rhetorical transformation takes place. They begin to think and talk as if the basic decision to subsidize had already been made -- only, the subsidies are now incarnated in the tax-system rather than in positive legislation. So they

come quickly to refer to all exemptions and allowances in our tax laws as "tax subsidies" or even "tax expenditures." But note what happens when you make this assumption and start using such terms. *You are implicitly asserting that all income covered by the general provisions of the tax laws belongs of right to the government, and that what the government decides, by exemption or qualification, not to collect in taxes constitutes a subsidy.* Whereas a subsidy used to mean a governmental expenditure for a certain purpose, it now acquires quite another

meaning -- i.e., a generous decision by government not to take your money.

When a man makes a tax deductible gift to charity, whose money has he given away? Traditionally, it has been thought that he gives away his own money, and that the tax deduction exists only to encourage him to give away his own money for such a purpose. Today, however, one hears it commonly said that he has only in part given away his own money -- in actuality, he has also given away some "public" money. This "public" money consists of that sum which, were no such deductions permitted by law, he would have to pay in taxes. It is then said -- indeed, it is now a cliché -- that the object of his philanthropy (a museum, say) is "*in effect*" being subsidized by public monies.

What we are talking about here is no slight terminological quibble. At issue is a basic principle of social and political philosophy -- the principle that used to be called "private property." The conversion of tax incentives into "tax subsidies" or "tax expenditures" means that "*in effect*" a substantial part of everyone's income really belongs to the government -- only the government, when it generously or foolishly refrains from taxing it away, tolerates our possession and use of it. To put it another way, when you start talking glibly of some \$70 billion of legal deductions and allowances as "tax subsidies," you have already in imagination socialized that amount of personal and corporate income. (Kristol, at 14-15) (emphasis in original)

⁸P.L. 93-344, July 12, 1974, 88 Stat. 278ff. For a discussion of the current effect of the "tax expenditure" concept in the Congressional budget process, especially Senator Kennedy's proposal to require review of each newly proposed "tax expenditure" by the authorization and appropriation committees responsible for its direct budgetary equivalents or counterparts prior to its consideration by the Senate Finance Committee or the House Committee on Ways and Means, see 50 National Journal 1908 (December 10, 1977).

⁹Professor Surrey is publicly the most well-known but not the only proponent of this "tax expenditure" concept. See, for example, articles in Pechman (editor), Comprehensive Income Taxation (1977); McDaniel, "Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction," 27 Tax Law Review 377 (1972); and Davies, "The Charitable Contributions Credit: A Proposal to Replace Section 501 (c) (3) Tax Exemption Organizations," 58 Cornell Law Review 304 (1973).

¹⁰See, for example, Special Analyses, Budget of the United State Government, Fiscal Year 1978, pp. 128-30; Congressional Budget Office, Five Year Projections, Fiscal Years 1978-1982: Supplemental Report on Tax Expenditures (GPO, 1977). Note also, that this agenda, this listing of "tax expenditure", includes in addition to the charitable deduction such items of interest to higher education as the exclusion from income of scholarships and fellowships, and the dependency deduction for children over 18 pursuing higher educational courses of study.

¹¹During consideration of the 1976 Tax Reform Act, this annual announcement played a major role. Many of these high income taxpayers were able to escape heavy taxation first, by making several adjustments to gross income (exclusion of one-half of long-term capital gains, for instance), to reduce their adjusted gross incomes, and second, by then adding up large amounts of itemized personal deductions (interest expenses, medical expenses, property taxes, casualty losses, charitable contributions, etc.) and subtracting these from adjusted gross income to reduce their taxable incomes to very low levels. To some extent, the 1969 Tax Reform Act tried to adjust for the effect of the first type of adjustments by enacting the minimum tax on tax preference income, an additional, now 15 percent, tax on certain items of income excluded from regular taxation. For reasons largely having to do with allowable deductions from the minimum tax base, however, the minimum tax was still not reaching every high income taxpayer previously able to pay no taxes at all. Thus, in 1976, the Congress created a new item of tax preference income -- itemized deductions in excess of 60 percent of adjusted gross income. The purpose was to ensure that every high income taxpayer would pay at least some minimum level of taxes.

¹²Feldstein, Martin S. and Amy Taylor, "The Income Tax and Charitable Contributions: Estimates and Simulations with the Treasury Tax Files," 3 Research Papers Sponsored by The Commission on Private Philanthropy and Public Needs, pp. 1419, 1436 and Table 6 at 1435.

¹³Technically, the standard deduction no longer exists in tax law. As of January 1, 1977, it has been replaced with a flat amount adjustment the law calls "zero bracket amount." This amount depends on a taxpayer's filing status. There are three different categories of filing status, and the zero bracket amounts corresponding to them are \$1600, \$2200, and \$3200. These no longer involve separate deductions as such; instead the equivalent amount is built into the tax tables and tax rate schedules. Since these amounts are built into the tables and rate schedules, taxpayers itemizing deductions will have to make an adjustment in their calculations so as not to receive the benefit of both the "zero bracket amount" and their "itemized personal deductions." Obviously, however, any future increase in the "zero tax bracket" amounts will have the same effects on charitable giving as have had increases in the standard deduction. See Department of the Treasury, Internal Revenue Service, 1977 Instructions for form 1040, at p. 3.

¹⁴President's Tax Message to the Congress, January 20, 1978.

¹⁵Smith, Hayden, Council for Aid to Education, New York, New York (Unpublished Analysis).

¹⁶For example, philanthropic leaders might argue that every taxpayer should be able to take a deduction for charitable giving, whether or not he files the short form (1040A) or the long form (1040), and whether or not he itemizes personal deductions. This is often commonly referred to as "moving the deduction above the line," meaning

1/30/78

making the charitable deduction a deduction from gross income, not from adjusted gross income, adjusted gross income being the "line." The result would be partially to protect the charitable deduction from future increases in the "zero bracket amount" (formerly, the standard deduction).

- ¹⁷ Boskin, Michael J., "Estate Taxation and Charitable Bequests," 3 Research Papers Sponsored by the Commission on Private Philanthropy and Public Needs [The Filer Commission], pp. 1453, 1477 (1975).
- ¹⁸ Caffrey, John and Herbert H. Issacs, Estimating the Impact of a College or University on the Local Economy, American Council on Education, Washington, D.C. (1971).

BASIC FEDERAL TAX ISSUES

in

HIGHER EDUCATION

Eight basic federal tax issues affecting higher education have been recurrent themes ever since the debate leading to the 1969 Tax Reform Act. They do not begin to exhaust the list of such specific tax matters. They are, however, the ones that are either likely to be part of the Congressional agenda in 1978-79 or that would be raised by any comprehensive tax legislation proposed by the Administration or by Members of Congress.

The eight issues are:

- (1) Preservation of the basic charitable deduction against alternatives such as a tax credit for charitable contributions.
(Deduction, Not a Credit).
- (2) Maintenance of the charitable deduction against efforts to require a qualifying floor before giving is deductible.
(Deduction Without Floor).
- (3) Extension of the eligibility for the charitable deduction to every taxpayer by moving the deduction "above-the-line".
(Deduction for All Taxpayers: "Above-the-Line").
- (4) Maintenance of the full fair market value deductibility of charitable gifts of appreciated property.
(Fair Market Value Deductibility of Appreciated Property).
- (5) Protecting the charitable deduction from the effects of the Minimum Tax on Preference Income.
(Minimum Tax).
- (6) Exclusion of charitable bequests of appreciated property from any proposals or law that would tax capital gains at death.
(Exclusion from Taxation of Gains at Death).
- (7) Maintenance of the unlimited, 100 percent estate tax charitable deduction.
(Unlimited Estate Tax Charitable Deduction).

- (8) Maintenance of the exclusion of scholarships and fellowships from income, and improvement in the definitions and tests for determining the tax status of such grants.
(Exclusion of Scholarships).

Following is a summary of each of these eight issues. For the sake of brevity, and to avoid duplication with the "Tax Studies" papers, no sources will be given for the assertions made in these summaries. Each "Tax Study" paper will present detailed arguments, with the appropriate citation of sources and references, for each of these issues. These summaries are intended only to give readers a flavor of the arguments about each issue. For those readers who wish to examine some of the sources on which these summaries draw, see the listing, "Selected Readings in Taxation and Higher Education," attached as part of this initial installment of A Guide to Tax Policy and Higher Education, in particular, the papers by Feldstein, Boskin, Clotfelter, Taylor, Mansfield, Groves, and Myers from Research Papers Sponsored by the Commission on Private Philanthropy and Public Needs, and the papers by Andrews, Bittker and Levi.

Deduction, Not a Credit

Some people have urged that an income tax credit be given for charitable contributions instead of the deduction. A tax credit is a direct reduction in taxes; a tax deduction is a reduction in income liable to taxation. For instance, if a tax credit of 30 percent of the value of a taxpayer's gifts to charity were substituted for the charitable deduction, and if a taxpayer gave \$100 to charity during the year, he would be able to subtract \$30 from his taxes, rather than to subtract \$100 from his income.

The effect of a credit versus a deduction on an individual taxpayer can be illustrated by looking at the above example. Under a 30 percent credit, every taxpayer giving \$100 saves \$30 in taxes (assuming each taxpayer's tax bill is at least \$30; if some owe less, then the credit will be only good for the actual amount of taxes owed). Under a deduction, a taxpayer giving \$100 also saves \$30 in taxes if he is in the 30 percent tax bracket. If his tax bracket is higher than 30 percent, he will save more than the \$30 in taxes for making the \$100 gift. If his tax bracket is lower than 30 percent, he will save less than \$30 in taxes for making the \$100 gift.

There are four problems with an income tax credit instead of a deduction for charitable giving. First, there are good reasons to argue that the deduction is theoretically correct, that a deduction for charitable giving is essential to the proper measurement of net income, which, under the dominant theory of personal income taxation, is the best approximation of the ability-to-pay. Net income is comprised of the new consumption plus new saving (including the net increase in the market value of property owned by the taxpayer) during the relevant taxing period. But charitable giving represents the voluntary transfer of private resources to public use. It is neither a form of personal con-

sumption nor personal savings. Therefore, it must be deducted in order to determine true net income, the measure of one's ability-to-pay, that is, to consume or save out of current receipts or out of the net increase in market value in property owned by the taxpayer.

Second, the net effect of substituting for the charitable deduction a credit ranging from 20 to 30 percent, the range most often discussed in public debate, would be to increase total charitable contributions, but to decrease giving to education, museums, and hospitals. A credit much lower than 20 percent would tend to decrease giving to all charities; a credit of approximately 50 percent would increase both total giving and giving to education, cultural organizations and hospitals, but the revenue loss to government would be extraordinarily high.

Third, the 20 to 30 percent tax credit approach, when compared to the charitable deduction, would have the "upside-down effect" of increasing personal disposable or "take-home" (after-tax, after-gift) income the more, the higher one's tax bracket.

Finally, the tax credit may well run afoul of the principle of separation of church and state, and be ruled unconstitutional with respect to religious organizations and charities.

Thus, the tax credit approach is theoretically questionable, and its practical consequences make it unacceptable.

Deduction Without Floor

Under current law, a taxpayer does not have to give a minimum amount to charity before he is allowed to take a charitable deduction. That is, the first dollar of charitable contributions is currently deductible by each taxpayer who itemizes his personal deductions.

Some persons have proposed allowing the deductibility of charitable gifts only to the extent that contributions exceed some minimum, called a qualifying "floor". This qualifying "floor" might be a flat dollar amount, such as \$100, or a percentage of adjusted gross income, such as 3 percent. This proposal would treat charitable giving much as medical expenses under current law, deductible only if quite large in relation to one's income.

This proposal is inadequate on both theoretical and practical grounds. First, a deduction for charitable giving is arguably necessary to define income properly. Allowing the deduction only to the extent gifts were in excess of some qualifying "floor" would mean taxing the person making the gift on more income than that amount which theoretically measures his ability-to-pay. All charitable gifts should in theory be fully deductible from gross income.

Second, there is already in the law a percentage of income limitation on the maximum amount of charitable giving a taxpayer can deduct in any year. While, in theory, if the charitable deduction is "income-defining", there should be no such maximum limitation, it does serve to

ensure that no taxpayer, solely because of his voluntary gifts to the public good, is entirely freed of some duty to pay some mandatory taxes for the same public good as well. While this limitation, even though a departure from the implications of tax theory, may be justified by considerations of political theory, there is no such justification for departing from tax theory by the adoption of a minimum or qualifying "floor" for the charitable deduction as well.

Third, it fails on practical grounds. Based on 1970 data, econometric studies estimate that a 3 percent floor would cut total giving by 20 percent and education gifts by 36 percent; a \$100 threshold would reduce total giving and reduce that to education by approximately 5 percent. New Treasury Department revenue would fall markedly short of the dollars lost to charity. Thus, a qualifying "floor" would serve only to reduce the number of private dollars voluntarily directed by individuals to the support of public purposes.

Fourth, it runs counter to the efforts of the Congress and the Administration to try and simplify the income tax system. A qualifying "floor" for the charitable deduction would unnecessarily complicate the tax law.

Finally, the "floor" proposal is advanced most often as an aid to the tax audit process by the Internal Revenue Service, as a mechanical means to reduce error and fraud in the claiming of deductions. The U.S. Treasury Department and the IRS argue that it would especially be necessary if the charitable deduction were made available to every taxpayer, whether filing the long form (1040) or the short form (1040A) and whether or not itemizing personal deductions.

But the audit problem is exaggerated. The IRS would, in effect, try to reduce audit problems by discouraging charitable giving, and in a way that not only would reduce substantially gifts to charity, but would reduce such gifts by more than it would boost tax revenues. Thus, at the substantial cost of net resources (taxes plus charitable gifts) devoted to public concerns, the IRS would try to control some error and fraud of minor significance, if any at all, hardly a cost effective approach. If there are audit problems at all, there are better ways of solving them than the use of qualifying "floor" that would severely depress total charitable giving in our society.

Deduction for All Taxpayers: "Above-the-Line"

Under current tax law, only those taxpayers who file the long income tax return (Form 1040), and itemize personal deductions are allowed to deduct their charitable contributions. Persons filing the short return (1040A) or not itemizing personal deduction but instead using the standard deduction (now called the "zero tax bracket amount") cannot take the deduction.

Each taxpayer should be able to take the charitable deduction, whether or not he itemizes personal deductions, and whether he files the long form or the short form, because charitable gifts represent the voluntary trans-

fer of private resources to public use. The purpose of taxation is to shift private resources available for personal consumption or saving to public uses. Charitable gifts should not be taxed, since they represent neither personal consumption nor personal savings, the measure of net income which is the basis of income taxation, but rather result in the voluntary shift of private resources to public uses. Only by allowing every taxpayer to take the charitable deduction can this objective be attained.

Such a change in the tax law would, according to econometric studies based on 1970 data, increase total charitable giving by 7 percent and would yield \$1.19 of new charitable giving for every \$1.00 of revenue lost by the Federal Treasury. It would also enhance the universality of participation by giving proper recognition to the public character of private philanthropy by all taxpayers. Currently, only 25 percent of all taxpayers itemize deductions. Less than ten years ago, 50 percent did so. This percentage would shrink to 15 percent under some tax proposals now pending before Congress. Finally, extending the charitable deduction to all taxpayers would underscore the uniqueness of private giving as the keystone of this nation's pluralistic society, and the uniqueness of the charitable deduction as the one provision in the tax code that allows a deduction for sharing one's income with the whole community instead of spending it on oneself.

Full Fair Market Value Deductibility of Charitable Gifts of Appreciated Property

Under current tax law, persons making charitable gifts of certain kinds of property are able to take the full fair market value of that property as a charitable deduction up to a ceiling of 30 percent of their adjusted gross income. It is called appreciated property. Such property, if sold, would give rise to capital gains income, and has appreciated in value. This means that its current market value is greater than the value of the property at the time it was acquired by the taxpayer, the difference in value being called appreciation.

There are two threats to this provision of tax law that is of great benefit to charitable giving. One is direct; the other indirect.

Some people have proposed directly eliminating the full fair market value deductibility for charitable gifts of appreciated property, limiting the deduction to original cost (with appropriate adjustments if any) or to original cost plus 50 percent of appreciation, on grounds of tax theory. They argue that not only is there the value of the deduction, but that the value of the appreciation never is included in the giver's gross income. Thus, they conclude, the donor receives two benefits: tax savings from the charitable deduction itself, and savings from the permanent exclusion of the net appreciation from his income.

Indirectly, full fair market value deductibility might be eliminated if the current tax treatment of long term capital gains were eliminated. This would depend on how carefully such a provision were drafted. Ac-

cordingly, if legislation were adopted to tax capital gains income as ordinary income, an amendment might be necessary to preserve the full fair market value deductibility for charitable gifts of appreciated, or capital gains, property.

There are several arguments for preserving this treatment of such charitable gifts:

First, the U.S. income tax system currently does not tax appreciation until property is sold or exchanged for something else of value. But a person giving away property to charity is not selling it or exchanging it for personal value; rather he is donating it for the use and benefit of the public. Such a gift should not be treated as giving rise to income. Moreover, this would be consistent with the way in which noncharitable gifts of appreciated property are treated in tax law. Such gifts do not give rise to income for the donor. Rather the recipient takes the donor's cost of the gift as his cost for purposes of determining net appreciation in the event of his future sale or exchange of the property. When the recipient sells, he then pays any tax due on the appreciation. Gifts to charity are treated in the same way; the cost is carried over to the charity ("carry-over" basis) and tax liability is triggered upon sale or exchange by the charity. But there is never any tax due because Congress has declared that charities are to be taxed at a zero bracket rate.

Second, as a practical matter, the elimination or substantial narrowing of the fair market value deductibility of gifts of appreciated property would cost charities, according to econometric studies based on 1970 data, as much as \$1.33 in gifts for every new dollar of revenue gained by the Treasury. This loss would strike hard at every charity, especially in the areas of general fund campaign leadership gifts and of capital gifts.

Third, if the law were changed, many taxpayers would simply hold onto their property. They would not sell, exchange or give it away. As a result, there would be substantial losses in charitable giving, little new tax revenue, and continued deferral of taxation with respect to the appreciation in the property. Moreover, with respect to the contingent liability associated with the property that continues to be held by the taxpayer, that is, the capital gains tax being deferred on the value of the appreciation in the property, the present discounted value of that contingent tax cost to the taxpayer diminishes almost to zero the longer the taxpayer plans and is able to hold onto the property in question. And, of course, the wealthier a taxpayer is, the longer in general, he will be able to plan and actually hold onto property. Thus, only the public beneficiaries of the charitable services would lose out.

At the same time, the higher one's income, the more personal income would be available to taxpayers, compared with present law, if the law were changed. Such a change would also mean fewer voluntary transfers, during lifetime of the donors, of wealth from private hands to public uses through charitable activity. Thus, the full fair market value deductibility for gifts of appreciated property actually increases the total flow of resources (taxes plus charitable gifts) to public purposes and increases the rate at which property and wealth are dispersed throughout or for the

use of society during the lifetimes of any group of taxpayers, and in a manner consistent with the pluralistic character of American society.

Minimum Tax

Under current law there is in addition to the regular individual income tax a minimum tax on tax preference income. The purpose of this tax is to ensure that every taxpayer, especially those with high gross incomes, but low adjusted gross incomes or low taxable incomes because of eligibility for a variety of exclusions, exemptions and deductions available in the tax code, pays a minimum amount in income taxes. Certain exclusions or deductions or exemptions are called under this law "tax preferences". The value of these are added up and are called the minimum tax base. Then, certain deductions are allowed from this minimum tax base, and a tax of 15 percent is assessed against what remains.

This minimum tax was created in 1969, largely in response to Treasury studies showing that several hundred millionaires and other high income persons were paying little or nothing in federal income taxes. Because of certain allowable deductions from the minimum tax base, in 1976, the minimum tax was still not accomplishing its purpose. Thus, in the 1975 Tax Reform Act there was placed a new provision, a new item of tax preference income, described as the sum of itemized personal deductions in excess of 60 percent of adjusted gross income. The practical effect of this new item for inclusion in the minimum tax base is that no taxpayer reporting any gross income at all will be able to avoid paying some income tax.

There are many ways in which the minimum tax can affect the charitable deduction. The 1976 amendment, creating the new item of "tax preference income" -- itemized personal deductions in excess of 60 percent of adjusted gross income -- included charitable giving within its scope, but careful econometric studies showed that it would have no effect in the aggregate or with respect to broad classes of charitable organizations on the levels of charitable giving. Nonetheless, it does have an effect on charitable giving by some individuals.

Other ways in which the charitable deduction might be affected in the aggregate by changes in the minimum tax include such proposals as making the appreciated part of gifts of appreciated property an item of "tax preference income", lowering the percentage in the "tax preference" item "deductions in excess of 60 percent of adjusted gross income" to 50 percent or less, increasing the minimum tax rate, and changing the allowable deductions from the minimum tax base.

The goal for the charitable community concerning the minimum tax is to test the specifics in any minimum tax measure to measure the impact on giving and to devise alternatives to offset any harm to giving threatened by such changes. Getting charitable giving out of the minimum tax altogether by moving the deduction "above-the-line" and making it available to every taxpayer as a proper "income-defining" deduction would be of significant benefit with respect to the minimum tax as well as with respect to the regular income tax.

Exclusion of Appreciated Property Gifts from Taxation of Gains at Death

The individual income tax does not tax the year-to-year gains in the market value of property held by a taxpayer. Under current law, there is no income taxation at death, either, on the net gains in value accumulated in property since the time of its acquisition. The property goes into the estate and is valued at current fair market value. Then an estate tax is levied on this amount after appropriate adjustments. What is left passes to the heirs and other recipients of bequests. The value of the property at the time of original acquisition, adjusted for estate taxes paid and for other appropriate costs, is "carried-over" under the new law enacted in 1976 to the heirs or other recipients for their own tax purposes.

Some people have proposed an income tax at death on the value of the appreciation in the property in the estate. Such an income tax on unrealized capital gains at death would have a dramatically adverse impact on bequests of appreciated property unless charitable gifts were specifically exempted from such a tax. This income tax would be in addition to the estate tax.

The practical effect of such a tax would be to force the sale of much of the property and a payment of a substantial income tax to the government. This would leave much less in the estate to be given to the charities listed in the decedent's will, or to any other heirs or recipients of bequests. This would wreck havoc on the estate tax marital deduction as well, and an exemption here would be necessary lest the value of property left for the widow/widower plummet. Thus, even if the unlimited 100 percent estate tax charitable deduction were maintained, the effect of such an income tax on gains at death would leave fewer resources in the estate to be given to charity.

Some tax experts have proposed a flat rate, additional estate tax (AET) as an alternative to the proposed income tax on capital gains at death. The AET would impose a flat rate tax on the total value of the appreciation of all property in the estate. This would be in addition to the usual estate tax. Just as in the case of the proposed income tax on capital gains at death, bequests to charity should be excluded from AET.

Bequests are a major source of endowment funds, and typically some in the form of appreciated property. As with life-time appreciated property gifts, preservation of the full deductibility of bequests of appreciated property in any income tax system must be maintained.

Unlimited Estate Tax Charitable Deduction

Current tax law allows an unlimited 100 percent estate tax charitable deduction. Proponents of limiting this deduction to 50 percent of the value of the estate rely on two arguments: (1) to make tax treatment of the federal estate tax charitable deduction consistent with that of the federal individual income tax charitable deduction; and (2) to increase revenue from the federal estate tax.

The first argument fails to distinguish the legislative purpose of the estate tax from that of the income tax. The legislative purpose of the estate tax is to limit excessive intergenerational transfers of wealth within each family. The 100 percent unlimited estate tax charitable deduction serves this fundamental purpose of estate taxation very well by encouraging people during life and at death to give their property to charitable organizations which carry out public purposes and serve public needs.

A 1975 econometric study by Professor Michael Boskin of Stanford University shows that a 50 percent limitation on the estate tax charitable deduction would cost charity \$4.40 in gifts for every \$1.00 of revenues gained. This \$3.30 difference for every \$1.00 of revenues gained would pass on to the heirs of the decedents, thus increasing, relative to existing law, the intergenerational transfers of wealth within individual families. Thus, the proposed change would directly conflict with the fundamental purpose of the federal estate tax.

Second, the Boskin study also reveals that the proposed change would only increase estate tax revenues by tens of millions of dollars, not by the hundreds of millions predicted by proponents of this change. At the same time, gifts to charity would decline by \$4.40 for every \$1.00 of new revenue. This would result in a severe decline in the total resources, raised through the combination of the estate tax and of the estate tax charitable deduction, available to serve public needs.

The current law should be retained unchanged. The 100 percent unlimited estate tax charitable deduction is a powerful and fair mechanism for shifting substantial resources from private use and consumption to public use and benefit through bequests to charitable organizations.

Exclusion of Scholarships

Scholarships and fellowships (to a limited extent) are excluded by statute from taxation. But there are constant battles with the Internal Revenue Service (IRS) over the eligibility of various public and private awards or forms of financial assistance to students and scholars for this tax treatment. Examples of recent types of awards challenged by the IRS include tuition remission programs, loan forgiveness features of certain student loan programs, and various federal scholarships containing mandatory service or pay-back provisions, such as the National Research Service Awards.

The Staff of the Joint Committee on Taxation of the U.S. Congress, at the direction of the House Committee on Ways and Means and the Senate Committee on Finance, is currently conducting a study of the tax treatment of fellowships, scholarships, and employer-sponsored employee educational or training programs. The higher education community has a major stake in the outcome of this study.

SELECTED READINGS IN
TAXATION AND HIGHER EDUCATION

American Association of Fund Raising Counsel, Inc., GIVING USA, 1977 Annual Report. New York: 1977.

Andrews, William D., "A Consumption-Type or Cash Flow Personal Income Tax," 87 Harvard Law Review 1113 (1974).

Andrews, William D., "Personal Deductions in an Ideal Income Tax," 86 Harvard Law Review 309 (1972).

Association of American Universities, Tax Reform and the Crisis of Financing Higher Education. Washington: Association of American Universities, 1973.

Association of the Bar of the City of New York, "Proposal for Limitation on the Use of Tax Incentives," A Report by the Committee on Taxation. New York: 1976.

Bittker, Boris I. and C. Galvin, R. Musgrave and J. Pechman, A Comprehensive Income Tax Base? A Debate. (1968)

Bittker, Boris I., "Charitable Contributions: Tax Deductions or Matching Grants," 28 Tax Law Review 37 (1972).

Break, George F. and Pechman, Joseph A., Federal Tax Reform: The Impossible Dream? Washington: The Brookings Institution, 1975.

Coalition for the Public Good, The Charitable Deduction: Its Role in Preserving a Viable Public-Private Relationship. Alexandria, Virginia: 1975.

Commission on Private Philanthropy and Public Needs (The Filer Commission), Giving in America: Toward a Stronger Voluntary Sector. Washington: Department of the Treasury, 1975.

1/30/78

Commission on Private Philanthropy and Public Needs (The Filer Commission) Research Papers Sponsored by the Commission on Private Philanthropy and Public Needs (Five Volumes), Washington: Department of the Treasury, 1977. (Hereinafter, abbreviated Filer).

Michael J. Boskin and Martin S. Feldstein, "Effects of the Charitable Deduction on Contributions by Low-Income and Middle-Income Households: Evidence from the National Survey of Philanthropy," 3 Filer 1441, (1975).

Michael J. Boskin, "Estate Taxation and Charitable Bequests," 3 Filer 1453, (1975).

Cheit, Earl and Theodore Lobman III, "Private Philanthropy and Higher Education: History, Current Impact and Public Policy Considerations," 2 Filer 453, (1975).

Commentary on Commission Recommendations; Donee Group Report. 1 Filer 3.

Martin S. Feldstein, "Charitable Bequests, Estate Taxation, and Intergenerational Wealth Transfers," 3 Filer 1485, (1975).

Martin S. Feldstein and Charles Clotfelter, "Tax Incentives and Charitable Contributions in the United States: A Micro-economic Analysis," 3 Filer 1393, (1975).

Martin S. Feldstein and Amy Taylor, "The Income Tax and Charitable Contributions: Estimates and Simulations with the Treasury Tax Files," 3 Filer 1419, (1975).

Jenny, Haus H. and Mary Allen, "Philanthropy in Higher Education: Its Magnitude, Its Nature and Its Influence on College and University Finance," 2 Filer 515, (1975).

Mansfield, Harry K. and Ronald Groves, "Legal Aspects of Charitable Contributions of Appreciated Property to Public Charities," 4 Filer 2251, (1975).

Myers, John Holt, "Estate Tax Deduction for Charitable Benefits: Proposed Limitations," 4 Filer 2299. (1975).

Council for Financial Aid to Education, Voluntarism, Tax Reform, and Higher Education. New York: Council for Financial Aid to Education, 1975.

Council for Financial Aid to Education, Voluntary Support of Education, 1975-76. New York: 1977.

Covey, Richard B., "Possible Changes in the Basic Rule for Property Transferred by Gift or a Death," Taxes-The Tax Magazine 831 (1972).

Davies, John H., "The Charitable Contributions Credit: A Proposal to Replace Section 501 (c)(3) Tax-Exempt Organizations," 58 Cornell Law Review 304 (1973).

Department of the Treasury, Blueprints for Basic Tax Reform. Washington: 1977.

Goode, Richard, The Individual Income Tax. Revised Edition. Washington: The Brookings Institution, 1976.

Kennedy, Senator Edward M., "Compendium of Papers on Federal Tax Reform," Congressional Record S-11591 (daily ed. July 2, 1976).

Levi, Julian H., "Financing Education and the Effect of the Tax Laws," in Law and Contemporary Problems: Federal Taxation and Charitable Organizations, Vol. XXXIX, No. 4. Durham, North Carolina: Duke University Press, Autumn 1975.

Levi, Julian H. and Sheldon Steinbach, Patterns of Giving to Higher Education III: An Analysis of Voluntary Support of American Colleges and Universities 1973-74. Washington, D.C.: American Council on Education, 1975.

McDaniel, Paul, "Alternatives to Utilization of the Federal Income Tax System to Meet Social Problems," 11 Boston College Industrial and Commercial Law Review 867 (1970).

McLure, Charles E. Jr., "Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals," 88 Harvard Law Review 532 (1975).

Pechman, Joseph A. (ed.), Comprehensive Income Taxation. Washington: The Brookings Institution, 1977.

Peterson, George E. (ed.), Property Tax Reform. Washington: John C. Lincoln Institute and Urban Institute, 1973.

Staff of the House Committee on Ways and Means, 94th Congress, 2nd Session, "Background Materials on Federal Estate and Gift Taxation." Washington: 1976.

Stern, Emil, Jr., "Federal and State Tax Policies," in Public Policies and Private Higher Education, edited by David M. Breneman and Chester Finn, Jr. Washington, D.C.: The Brookings Institution, to be released in April 1978.

1/30/78

Surrey, Stanley S., "Federal Income Tax Reforms: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Government Assistance," 84 Harvard Law Review 352 (1970).

Surrey, Stanley, "Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures," 83 Harvard Law Review 705 (1970).

Surrey, Stanley, Pathways to Tax Reform. Cambridge, Massachusetts: Harvard University Press, 1973.

Surrey, Stanley, "The Federal Tax Legislative Process." 31 Record of the Association of the Bar of the City of New York 509 (1976).

1/30/78

A GUIDE to TAX POLICY and HIGHER EDUCATION

A Looseleaf Reference Service
on
Tax Issues Affecting Higher Education

February 1978

Prepared By

The National Association of Independent Colleges and Universities

in cooperation with

The American Council on Education

The Association of Governing Boards

The Council for Advancement and Support of Education

Publication Notes

The Ohio Board of Regents is providing copies of this publication to all trustees of public and independent colleges and universities in the State of Ohio.

NAICU wishes to acknowledge with grateful appreciation the support and assistance received from the Association of American Universities and the Association of Jesuit Colleges and Universities, in addition to that of the three primary co-sponsoring associations, in the development of this publication.

©1978, by

National Association of Independent Colleges and Universities

Additional copies may be obtained for \$1.00 from the

Office of Research

NAICU

1717 Massachusetts Avenue, N.W., #503
Washington, D.C. 20036

A GUIDE to TAX POLICY and HIGHER EDUCATION

CONTENTS

- A. Introduction to A Guide to Tax Policy and Higher Education
- B. Some Basic Tax Issues of Interest to Higher Education
- C. Selected Readings in Taxation and Higher Education
- D. Tax Studies -- A Continuing Series of Papers on Specific Tax Issues Affecting Higher Education

Works in Progress, January, 1978:

- 1. Background on the Theory and Practice of Federal Taxation and the Charitable Deduction
- 2. The Case for the Charitable Deduction: History, Philosophy and Effect
- 3. The Case for the Charitable Deduction: A Deduction, Not a Credit
- 4. The Case for the Charitable Deduction: No Qualifying Floor
- 5. The Case for the Charitable Deduction: Extending Eligibility to Every Taxpayer
- 6. The Case for the Charitable Deduction: Full Fair Market Value Deductibility for Gifts of Appreciated Property
- 7. The Case for Scholarships and Related Awards: Exclusion from Income Taxation

INTRODUCTION
to
A GUIDE to TAX POLICY and HIGHER EDUCATION

Purpose	2
Spectrum of Tax Issues.	2
Initial Focus	6
Role of Presidents, Trustees and Friends.	7
Organization.	7
Contents.	8
Uses.	9

INTRODUCTION

to

A GUIDE to TAX POLICY and HIGHER EDUCATION

Purpose

A Guide to Tax Policy and Higher Education is intended to help presidents, trustees, and friends of higher education understand and act upon the many issues of tax policy that will affect their institutions.

Spectrum of Tax Issues

The list of tax issues affecting higher education is practically inexhaustible. Federal, state and local governments constantly scrutinize their tax laws to determine whether these are serving broad, publicly accepted purposes, and whether these could be made to produce greater revenues.

At the federal level, pressures have mounted over the last two decades for a comprehensive revision of federal tax policy and practice. Both the federal individual income tax and estate tax are being studied to determine if they are consistent with tax theory and if they serve efficiently and fairly the public purposes for which they were enacted.

Two provisions of extraordinary interest to higher education that have drawn considerable attention from tax experts in government, universities, research centers, the press, the legal community, and organized citizens groups are the individual income tax charitable deduction and the estate tax charitable deduction. The individual income tax basically allows a taxpayer who itemizes personal deductions to take a deduction for his gifts to public charities. He is, however, limited overall in any year to a deduction equal to 50 percent of his adjusted gross income, and is further limited to a deduction of 30 percent of adjusted gross income for gifts of property whose market value has increased over its value at the time of acquisition by the taxpayer, and which would produce capital gains income if sold (appreciated property). There are many technical rules, definitions and interrelationships that complicate this seemingly simple basic description. It is enough to point out that this basic provision, with all its complex detail, has been the subject of much controversy and criticism over the past decade.

Professor Stanley S. Surrey of Harvard Law School, who served as Assistant Secretary of the Treasury for Tax Policy under Presidents Kennedy and Johnson, published two seminal law review articles in

1970.¹ They were based in part on a comprehensive study of the federal tax laws he had authored while at the Treasury. They raised serious questions about the charitable deduction and other exclusions, exemptions and deductions in the Internal Revenue Code. While others had previously made similar points about individual parts of the personal income tax,² Professor Surrey's articles provided a sophisticated conceptual framework for examining all of its provisions and evaluating them by common standards.

The key elements of this framework were the concepts of "tax expenditures" and the "Tax Expenditure Budget".³ They were first introduced by him in a speech in late 1967 discussing the budgetary dilemmas confronting the Johnson Administration.⁴ He noted that Congress and the Administration were only examining the federal programs financed directly by Congressionally authorized expenditures, but not those financed, indirectly in his view, through Congressionally enacted provisions in the federal individual income tax system. To remedy this, he recommended categorizing the latter kind of "spending" programs, "tax expenditures", and creating an annual "Tax Expenditure Budget" to show the impact of these on public policy. The first was published by the Department of the Treasury in January, 1968.

Oversimplifying, the tax expenditure concept is developed as follows. The ability to pay is deemed to be the proper basis for personal taxation. Net income is the best approximate measure of ability to pay according to the dominant theory of individual income taxation.⁵ Certain deductions from gross income are essential to the calculation of net income. They are called income-defining deductions. Such deductions are considered to be an inherent part of the structure of an ideal income tax system. In general, under this theory, expenditures necessary for the earning or production of income are the only income-defining deductions. Any other deductions are non-income-defining and represent a departure from the ideal standard. They must be justified, if at all, by some other rationale than that of tax theory.⁶ According to Professor Surrey and other tax theorists generally in agreement with him, the non-defining deductions are classified as "tax expenditures". Because of each of these, the federal government collects less revenue than it would if the tax system allowed only theoretically essential deductions (or other adjustments to income). This lost or foregone revenue is, according to this concept, in effect "spent" through the tax system to accomplish certain public objectives, such as home ownership (home mortgage interest and real estate tax deduction), capital investment (accelerated depreciation and capital gains), and philanthropy (charitable deduction). He concluded that this tax "spending" should be periodically evaluated just as are, allegedly, those governmental programs for which Congress directly authorizes expenditures. Those "nonessential" tax deductions that prove to be effective, efficient and fair in accomplishing public objectives, compared to direct spending alternatives, might be retained in the tax law, but he doubted that many would upon analysis prove to be so justified. Otherwise, he argued that they should be repealed.

Of course, there are several major assumptions underlying these concepts, and there is disagreement over both the scope and validity of this conceptualization of the federal individual income tax system.⁷ But, for the moment, as reference points to public policy, these disagreements are almost purely academic. The tax expenditure concept has, at least for now, center stage and defines the terms of the debate.

These concepts were first used effectively in the debates leading to passage of the 1969 Tax Reform Act, which placed some significant limitations upon the charitable deduction. Since then, they have been firmly institutionalized into the federal governmental budget and tax processes by the enactment of the Congressional Budget and Impoundment Control Act of 1974,⁸ by the annual publication of a "Tax Expenditure Budget" by the Treasury Department, and by their general use in public discussions of issues in federal income taxation. In reality, Professor Surrey and other proponents of these concepts⁹ have set the agenda and provided the vocabulary for the debate on federal tax policy that has been underway since 1969. And, on that agenda, the charitable deduction is listed as an exception to or departure from the "normal" or ideal structure of the tax law.¹⁰

The scholarship of Professor Surrey and others was not the only factor directing public attention to the myriad provisions in the income tax. There was also a dramatic political factor. In January, 1969, just before leaving office, Secretary of the Treasury, Joseph W. Barr, announced that several hundred taxpayers with incomes in excess of \$100,000 per year were paying no or almost no taxes. He attributed this fact to their widespread use of various legitimate deductions, exemptions, exclusions, and reduced rates in the tax law such as special treatment of capital gains income, home mortgage and other interest expense deductions, medical expense deductions, and the charitable deduction. This, too, had a major impact on the debate over the 1969 tax reform legislation. Each year since 1969, a similar announcement¹¹ has been published by the Treasury Department, keeping public attention drawn to the detailed provisions of the tax code.

These two factors, one conceptual and one political, continue to dominate discussion of the income tax system. The charitable deduction is a conspicuous item on that comprehensive tax agenda. The 1969 Tax Reform Act placed some significant limitations on certain kinds of charitable giving. During the Congressional consideration of that bill, the charitable community barely defeated proposals of even greater consequence for private philanthropy. Since then, no truly direct attack on the deduction has succeeded.

But it is not only the direct challenges to the charitable deduction that can affect seriously charitable giving. Even where the focus is on other parts of the tax code seemingly unrelated to the charitable deduction, there can be harmful consequences for philanthropy. For example, last summer, the Secretary of the Treasury included in a late draft of tax proposals for possible consideration by the President recommendations for sweeping changes in the laws governing the sale or

exchange of so-called long term capital gains property. Had such changes been proposed, depending on the exact language of the legislation, they could have posed a severe threat to charitable giving. According to one econometric analysis of such a proposal, based on 1970 data, the potential cost in donations to all of education would have been eight percent of annual giving.¹²

An even more dramatic example is found in the so-called standard deduction.¹³ This is the provision in tax law that allows a taxpayer to deduct a flat dollar amount rather than itemizing personal deductions such as home mortgage interest payments, property, sales and gasoline tax expenses, casualty losses, medical expenses and charitable gifts. In 1970, despite the burdensome calculations and record-keeping, 50 percent of all taxpayers itemized their deductions rather than taking the standard deduction because this choice meant lower taxes for them. Since 1970, there have been five increases in the standard deduction. As a result, only 25 percent of all taxpayers today itemize their deductions. For the other 75 percent, taking the standard deduction means lower taxes than is possible by itemizing. Under President Carter's recent tax proposals, only 16 percent of all taxpayers would have any incentive to itemize deductions; 84 percent would take the standard deduction.¹⁴

What does this have to do with the charitable deduction? Quite simply, taxpayers who use the standard deduction cannot take the charitable deduction. They have, therefore, less incentive to make charitable contributions. There is no longer for them any public recognition given to the truly public character of their voluntary private gifts to institutions which serve the common goals of the community. As a result, they give less than they would have had they itemized their deductions.

This indirect effect on charitable giving of the increasing proportion of taxpayers taking the standard deduction has been measured; its magnitude is extraordinary. Recent studies¹⁵ have estimated that charities have lost about \$5 billion in gifts from 1970-1976 because of increased use of the standard deduction. These same studies estimate that this factor will have caused an additional loss of another \$1.357 billion in annual charitable giving in 1977.

These immediate losses in annual giving, however, are the least of the harmful consequences of this trend. Over the longer run, younger alumni and alumnae, who will increasingly tend to use the standard deduction, will be less likely to develop early the habit of annual giving. The effect of this on annual giving will not be noticeable for a decade or more; by then, it will be too late. Of equal concern, as ever smaller numbers of taxpayers itemize, the universal character of charitable giving will be lost and the deduction will become politically vulnerable. As only the very well-to-do continue to itemize, the charitable deduction will appear to lose its unique status as the one deduction in the code that is given not for spending income on oneself, but for sharing it with the whole community. While leaders

of higher education cannot and should not oppose increases in the standard deduction, they should be searching for and advocating ways to offset the negative effects these increases have on charitable giving.¹⁶

Similar criticisms and problems arise in connection with the estate tax charitable deduction. Basically, in determining the value of the estate that will be subject to taxation, the law allows an unlimited deduction for bequests to charity. While, as in the case of the individual income tax charitable deduction, there are complicating details, this basic characteristic of the estate tax is central to this GUIDE. The critics of the estate tax charitable deduction often focus on its unlimited character, especially in contrast to its income tax counterpart, as well as on its alleged interference with the estate tax' revenue potential and that tax' purpose to discourage intergenerational transfers within the same family of the control over or the ownership or use of property.

In addition to such direct questions about this deduction, indirect problems also arise at the boundary between income taxation and estate taxation. This is especially so with respect to periodic proposals for the taxation of the appreciation (basically, the difference between current market value and the value at the time the property was acquired by the taxpayer) in property in the estate at the time of death, either through the income tax or through an added provision in the estate tax.

While the estate tax charitable deduction has not been as publicly a target of the "tax expenditure" school of tax theory as has the income tax provision, it has, nonetheless, been a target of critics of the estate tax system. The importance of this deduction to higher education, however, cannot be overstated. One estimate is that placing a 50 percent limit on the deductibility of charitable bequests would cost charities \$4.40 in gifts for every \$1.00 in added revenue for the government.¹⁷

Initial Focus

It is obvious that higher education has a crucial interest in the debate over the federal tax system. But the direct and indirect threats to charitable giving are not the only federal tax issues that will affect higher education. Among others are:

- (a) the exemption of charities from income taxation;
- (b) the integration of the corporate and individual income taxes;
- (c) the withholding of taxes against dividend income;
- (d) the unrelated business income tax;
- (e) the social security and other payroll taxes;

- (f) the exclusion from taxation of scholarships, fellowships and related awards; and
- (g) the dependency deduction for children over age 18 attending colleges or universities.

Finally, there are serious tax issues affecting higher education at the state and local levels. Such issues as exemptions from state income and sales taxes and from local property taxes are on the agendas of many state and local governments.

Because of their wide and immediate importance, the GUIDE will first be focussed upon issues affecting higher education arising from federal individual income and federal estate taxation. Initial attention will be given to issues involving the charitable deduction and scholarships, fellowships and employer-sponsored employee educational programs.

Role of Presidents, Trustees and Friends

Many educational leaders may not be fully aware of the direct or indirect effects of proposed tax legislation on, for example, charitable giving, or of the alternatives to such tax proposals that would eliminate or lessen any negative impact on philanthropy. Trustees, on the other hand, some of whom may be more generally familiar with the complexities and interactions of tax law, may not always be aware of the full consequences of certain tax policies for non-profit institutions. That tax issues are usually relegated to experts, who often write and speak only to other experts, only compounds these difficulties. Past experience, at least since 1969, makes it clear that tax policy is too important to be left only to experts. Educational leaders now must be well-informed students of major tax issues and persuasive advocates for the tax policies that enable their institutions to accomplish the public purposes entrusted to them. To this end, presidents, trustees and friends need succinct and timely information on proposed tax legislation so that they may determine by debate and discussion the tax proposals that will best serve the public goals of higher education. Such discussion will help them develop coherent positions on tax bills and a basis for informing members of the Congress and the Administration of the impact of a given tax policy upon their own institutions, and in concert with other philanthropic leaders, of its effect upon the whole community.

Organization

This GUIDE is designed to serve as a current reference to the tax issues affecting higher education and private philanthropy. It is organized in loose-leaf style, for filing in a three-ringed notebook, so that amended, up-dated, or new information can be easily incorporated. This format will also allow individual users to add to their

GUIDE such items as legislative status bulletins, memoranda of discussions with relevant governmental officials, other readings on tax policy, and compilations of local statistics and anecdotes on the economic and social contribution of higher educational and other philanthropic institutions to their local communities, congressional districts, or states.

Contents

This GUIDE will offer precise identification and thorough analysis of tax policy issues confronting higher education in a concise and timely manner. It will contain:

- (a) This introductory paper, "Introduction to A Guide to Tax Policy and Higher Education," to explain the purpose, organization and uses of this reference service.
- (b) A paper, "Some Basic Tax Issues of Interest to Higher Education," listing the principal tax issues affecting higher education which are most likely to arise during 1978-79 or during consideration of comprehensive tax legislation. There will be periodic supplements to this paper as additional issues arise.
- (c) A listing, "Selected Readings on Taxation and Higher Education," several basic references on tax theory and tax issues affecting higher education for those who wish to read more deeply. There will be periodic supplements to this list.
- (d) A paper, "Background on the Theory and Practice of Federal Taxation and the Charitable Deduction," to show how the charitable deduction fits into the overall federal tax system, to explain the questions raised by some of the critics of the charitable deduction, and to list some of the responses to these criticisms.
- (e) The papers, "Tax Studies," a continuing series of concise and timely reports on each of the specific tax issues affecting higher education that may arise in the tax legislature process. These will include reports on each of the subjects in the paper, "Some Basic Tax Issues of Interest to Higher Education." Each report will present a statement of the issue, an analysis of its impact on higher education, a summary of the theoretical and policy arguments for and against the issue, a presentation of any empirical evidence about the issue, and a summary of any alternative policies that might be pursued.
- (f) Briefing documents, two-page summaries of each of the major issues covered by the "Tax Studies," designed to assist public discussion about specific tax proposals.

Uses

Leaders of higher education and other charities in each community and region can enhance the persuasiveness and usefulness of these studies by the addition of local statistics and anecdotes. These studies should serve as a foundation for marshalling local data to document the importance to higher education and the local public well-being of charitable giving. For example, local philanthropic leaders might add to a basic study the following kinds of information: (1) an accounting of the amount of charitable giving to local institutions; (2) a listing of the range of activities and persons helped by such gifts; (3) a listing of large gifts, particularly of appreciated property, and of specific major activities in small and large institutions made possible by them; (4) a cataloguing of anecdotes about specific gifts and the activities supported; and (5) an accounting of the economic benefits conferred on the local area by institutions of higher education and other charitable organizations.¹⁸

Anecdotes are critical. Anecdotes put life into numbers and give legislators, administrators and the public at large concrete reasons to recognize the importance to the existence and quality of higher education and the vitality of their communities of the present income and estate tax treatment of charitable giving.

If a college's board of trustees has not already created a small subcommittee on taxation it might wish to consider doing so.

It's files could become the repository of the data and anecdotal information just described; its members could be given first responsibility for developing the college's position on proposed tax legislation; they could; either formally or informally, associate themselves with similarly tax-conscious trustees of other charitable institutions in the community, and throughout the congressional district or state; and they could become the highly knowledgeable and effective spokesmen for the college's, and other charities', position on tax matters in a wide variety of forums.

The formation of such well-integrated networks of informed trustees, and other friends of philanthropy, across all the states and the majority of congressional districts, can go far toward insuring the charitable community against the potentially enormous losses that the next round of major tax legislation could produce.

NOTES

- ¹Surrey, "Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures," 83 Harvard Law Review 705 (1970); and Surrey, "Federal Income Tax Reforms: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Government Assistance," 84 Harvard Law Review 352 (1970).

For earlier discussions, of the "comprehensive income tax base" and "tax expenditure budget" concepts see generally: Bittker, Galven, Musgrave and Pechman, A Comprehensive Income Tax Base? A Debate (1968); Aaron, "What is a Comprehensive Tax Base Anyway?," 22 National Tax Journal 543 (1969); Bittker, "Accounting for Federal 'Tax Subsidies' in the National Budget," 22 National Tax Journal 224 (1969); Surrey and Hellmuth, "The Tax Expenditure Budget - Response to Professor Bittker," 22 National Tax Journal 528 (1969); Bittker, "The Tax Expenditure Budget - A Reply to Professors Surrey and Hellmuth," 22 National Tax Journal 538 (1969).

- ²See partial listing in note 1, supra. See also, for a popularization of many of the points made in these and other studies, Stern, The Great Treasury Raid (1965); and Stern, "Uncle Sam's Welfare Program - for the Rich," New York Times, April 16, 1972, (Magazine) at 28.

- ³For a more detailed discussion of these concepts, see Surrey, Pathways to Tax Reform (1973); and the references in n. 1, supra.

- ⁴Surrey, *ibid.*, pp. vii, 3-4.

- ⁵See H. Simons, Personal Income Taxation (1938), for the initial elaboration of the theory of personal income taxation upon which the concept of "tax expenditures" is based.

- ⁶This is indeed greatly oversimplified. As Surrey explains in Pathways, *op.cit.* at 17:

The building of an income tax requires two types of provisions that collectively perform the following two functions. First, they provide the answers to those aspects of (questions about a normative model for an income tax structure) that would essentially be treated in much the same way by any group of tax experts building the structure of an income tax and being governed in that task by all the requirements implicit in such a tax because it is an income tax. These answers then become the structural provisions which shape a normative income tax. As an illustration, in this first category fall matters relating to the measurement of net income and the time periods for inclusion of that income.

In every particular personal income tax law, there are also some adjustments to income (deductions, exclusions, exemptions) that are not truly part of a normative income tax, but which, although not theoretically "income-defining,"

do become structural parts of an income tax -- and essential to the operation of that tax -- and therefore are not tax expenditures. For example, as Treasury analysis indicates, the treatment of the family e.g., the tax burden on married couples in relation to single persons -- is not part of a normative income tax. There is no preordained method of treatment that follows from the decision to adopt an income tax. Countries properly differ in the treatment depending on their attitudes toward marriage or women in the labor force and other such social and economic questions. The levels of personal exemptions and tax rates, and the degree of rate progressivity, are other examples mentioned in the treasury analysis that would fall in this second category. The treatment of the corporation -- as a separate entity or its income integrated with that of the shareholders in some fashion -- is still another example. The provisions incorporating the decisions in these areas are not tax expenditures. But the decisions have to be made before the structure of the income tax is complete and the tax is ready to be applied. As a consequence, this set of provisions, while necessary to the construction of an income tax is shaped by processes different in character from the processes determining the provisions in the first category, also relating to the inherent structure of an income tax. The tax expenditure provisions are, then, the provisions that may be found in an income tax law but that do not serve the two functions set forth above. (Surrey, Pathways, at 17-18).

⁷ See generally Bittker, Galvin, Musgrave and Pechman, A Comprehensive Income Tax Base? A Debate (1968); and the other readings listed in n.l., supra. For example, Professor Bittker disagrees that there exists a sufficiently elaborated and specified theory to serve well as the foundation for an ideal or normative income tax. He would tend to view the federal personal income tax system as "an assemblage of value judgments on scores of issues that could plausibly have been decided differently. To bestow the label 'correct' on any of these human creations is to misuse the term." Bittker, "The Tax Expenditure Budget - A Reply to Professors Surrey and Hellmuth," 22 National Tax Journal 538, 542 (1969). See also, Andrews, "Personal Deductions in an Ideal Income Tax," 86 Harvard Law Review 309 (1972); and Andrews, "A Consumption-Type or Cash Flow Personal Income Tax," 87 Harvard Law Review 1113 (1974) for additional discussions of the theoretical and practical strengths and weaknesses of the use of normative models for analyzing personal income tax systems, and for a particular reference to the ordinary charitable deduction, but not the deduction for appreciated property to the extent the appreciation is never reported as gross income, as conceptually

an income-defining deduction. Finally, see Levi, "Financing Education and the Effect of the Tax Laws," 39 Law and Contemporary Problems: Federal Taxation and Charitable Organization 75 (Autumn 1975); and Kristol, "Taxes, Poverty and Equality," 37 Public Interest 3 (Fall, 1974) for critical analyses of the philosophy of the "tax expenditures" or "tax subsidy" concept:

The implicit assumption in the concept of "tax expenditures" that citizens owe their incomes to the United States, is reminiscent of the assumptions upon which feudal societies were organized. Consider, for example, how Harry A. Bigelow described the system of land holding in England during the time of Henry II.

It may, roughly, be compared to a pyramid: At the summit the pyramid was the king, who was, in legal theory, the owner of all land in England. Immediately under him were the great lords in the kingdom, holding the large tracts of land in the manner already mentioned. These tenants immediately under the king later received the name of "tenants in capite." Under the tenants in capite were various grades of intermediate or mesne tenants, and at the bottom of the pyramid may be said to be the tenants who were in actual occupation of the land, either personally or by their servants. ..Thus it may be said that, except for the highest and lowest grades, each person occupied a double relation. With respect to the person under whom he was holding he was a tenant, owing fealty and faith and feudal services, and entitled to receive protection from his lord. (Levi, at 78, citing H. Bigelow, Cases and Materials in Rights in Land 2,3, (3rd edition 1945))

and

Many economists and tax experts -- Stanley Surrey, most notably -- nevertheless do favor subsidies rather than tax incentives, and argue persuasively for them.

But in the course of making these arguments, a very interesting rhetorical transformation takes place. They begin to think and talk as if the basic decision to subsidize had already been made -- only, the subsidies are now incarnated in the tax system rather than in positive legislation. So they

come quickly to refer to all exemptions and allowances in our tax laws as "tax subsidies" or even "tax expenditures." But note what happens when you make this assumption and start using such terms. *You are implicitly asserting that all income covered by the general provisions of the tax laws belongs of right to the government, and that what the government decides, by exemption or qualification, not to collect in taxes constitutes a subsidy.* Whereas a subsidy used to mean a governmental expenditure for a certain purpose, it now acquires quite another

meaning -- i.e., a generous decision by government not to take your money.

When a man makes a tax deductible gift to charity, whose money has he given away? Traditionally, it has been thought that he gives away his own money, and that the tax deduction exists only to encourage him to give away his own money for such a purpose. Today, however, one hears it commonly said that he has only in part given away his own money -- in actuality, he has also given away some "public" money. This "public" money consists of that sum which, were no such deductions permitted by law, he would have to pay in taxes. It is then said -- indeed, it is now a cliché -- that the object of his philanthropy (a museum, say) is "*in effect*" being subsidized by public monies.

What we are talking about here is no slight terminological quibble. At issue is a basic principle of social and political philosophy -- the principle that used to be called "private property." The conversion of tax incentives into "tax subsidies" or "tax expenditures" means that "*in effect*" a substantial part of everyone's income really belongs to the government -- only the government, when it generously or foolishly refrains from taxing it away, tolerates our possession and use of it. To put it another way, when you start talking glibly of some \$70 billion of legal deductions and allowances as "tax subsidies," you have already in imagination socialized that amount of personal and corporate income. (Kristol, at 14-15) (emphasis in original)

⁸P.L. 93-344, July 12, 1974, 88 Stat. 278ff. For a discussion of the current effect of the "tax expenditure" concept in the Congressional budget process, especially Senator Kennedy's proposal to require review of each newly proposed "tax expenditure" by the authorization and appropriation committees responsible for its direct budgetary equivalents or counterparts prior to its consideration by the Senate Finance Committee or the House Committee on Ways and Means, see 50 National Journal 1908 (December 10, 1977).

⁹Professor Surrey is publicly the most well-known but not the only proponent of this "tax expenditure" concept. See, for example, articles in Pechman (editor), Comprehensive Income Taxation (1977); McDaniel, "Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction," 27 Tax Law Review 377 (1972); and Davies, "The Charitable Contributions Credit: A Proposal to Replace Section 501 (c) (3) Tax Exemption Organizations," 58 Cornell Law Review 304 (1973).

¹⁰See, for example, Special Analyses, Budget of the United State Government, Fiscal Year 1978, pp. 128-30; Congressional Budget Office, Five Year Projections, Fiscal Years 1978-1982: Supplemental Report on Tax Expenditures (GPO, 1977). Note also, that this agenda, this listing of "tax expenditure", includes in addition to the charitable deduction such items of interest to higher education as the exclusion from income of scholarships and fellowships, and the dependency deduction for children over 18 pursuing higher educational courses of study.

- ¹¹During consideration of the 1976 Tax Reform Act, this annual announcement played a major role. Many of these high income taxpayers were able to escape heavy taxation first, by making several adjustments to gross income (exclusion of one-half of long-term capital gains, for instance), to reduce their adjusted gross incomes, and second, by then adding up large amounts of itemized personal deductions (interest expenses, medical expenses, property taxes, casualty losses, charitable contributions, etc.) and subtracting these from adjusted gross income to reduce their taxable incomes to very low levels. To some extent, the 1969 Tax Reform Act tried to adjust for the effect of the first type of adjustments by enacting the minimum tax on tax preference income, an additional, now 15 percent, tax on certain items of income excluded from regular taxation. For reasons largely having to do with allowable deductions from the minimum tax base, however, the minimum tax was still not reaching every high income taxpayer previously able to pay no taxes at all. Thus, in 1976, the Congress created a new item of tax preference income -- itemized deductions in excess of 60 percent of adjusted gross income. The purpose was to ensure that every high income taxpayer would pay at least some minimum level of taxes.
- ¹²Feldstein, Martin S. and Amy Taylor, "The Income Tax and Charitable Contributions: Estimates and Simulations with the Treasury Tax Files," 3 Research Papers Sponsored by The Commission on Private Philanthropy and Public Needs, pp. 1419, 1436 and Table 6 at 1435.
- ¹³Technically, the standard deduction no longer exists in tax law. As of January 1, 1977, it has been replaced with a flat amount adjustment the law calls "zero bracket amount." This amount depends on a taxpayer's filing status. There are three different categories of filing status, and the zero bracket amounts corresponding to them are \$1600, \$2200, and \$2800. These no longer involve separate deductions as such; instead the equivalent amount is built into the tax tables and tax rate schedules. Since these amounts are built into the tables and rate schedules, taxpayers itemizing deductions will have to make an adjustment in their calculations so as not to receive the benefit of both the "zero bracket amount" and their "itemized personal deductions." Obviously, however, any future increase in the "zero tax bracket" amounts will have the same effects on charitable giving as have had increases in the standard deduction. See Department of the Treasury, Internal Revenue Service, 1977 Instructions for form 1040, at p. 3.
- ¹⁴President's Tax Message to the Congress, January 20, 1978.
- ¹⁵Smith, Hayden, Council for Aid to Education, New York, New York (Unpublished Analysis).
- ¹⁶For example, philanthropic leaders might argue that every taxpayer should be able to take a deduction for charitable giving, whether or not he files the short form (1040A) or the long form (1040), and whether or not he itemizes personal deductions. This is often commonly referred to as "moving the deduction above the line," meaning

1/30 78

making the charitable deduction a deduction from gross income, not from adjusted gross income, adjusted gross income being the "line." The result would be partially to protect the charitable deduction from future increases in the "zero bracket amount" (formerly, the standard deduction).

¹⁷ Boskin, Michael J., "Estate Taxation and Charitable Bequests," 3 Research Papers Sponsored by the Commission on Private Philanthropy and Public Needs [The Filer Commission], pp. 1453, 1477 (1975).

¹⁸ Caffrey, John and Herbert H. Issacs, Estimating the Impact of a College or University on the Local Economy, American Council on Education, Washington, D.C. (1971).

BASIC FEDERAL TAX ISSUES

in

HIGHER EDUCATION

Eight basic federal tax issues affecting higher education have been recurrent themes ever since the debate leading to the 1969 Tax Reform Act. They do not begin to exhaust the list of such specific tax matters. They are, however, the ones that are either likely to be part of the Congressional agenda in 1978-79 or that would be raised by any comprehensive tax legislation proposed by the Administration or by Members of Congress.

The eight issues are:

- (1) Preservation of the basic charitable deduction against alternatives such as a tax credit for charitable contributions.
(Deduction, Not a Credit).
- (2) Maintenance of the charitable deduction against efforts to require a qualifying floor before giving is deductible.
(Deduction Without Floor).
- (3) Extension of the eligibility for the charitable deduction to every taxpayer by moving the deduction "above-the-line".
(Deduction for All Taxpayers: "Above-the-Line").
- (4) Maintenance of the full fair market value deductibility of charitable gifts of appreciated property.
(Fair Market Value Deductibility of Appreciated Property).
- (5) Protecting the charitable deduction from the effects of the Minimum Tax on Preference Income.
(Minimum Tax).
- (6) Exclusion of charitable bequests of appreciated property from any proposals or law that would tax capital gains at death.
(Exclusion from Taxation of Gains at Death).
- (7) Maintenance of the unlimited, 100 percent estate tax charitable deduction.
(Unlimited Estate Tax Charitable Deduction).

- (8) Maintenance of the exclusion of scholarships and fellowships from income, and improvement in the definitions and tests for determining the tax status of such grants.
(Exclusion of Scholarships).

Following is a summary of each of these eight issues. For the sake of brevity, and to avoid duplication with the "Tax Studies" papers, no sources will be given for the assertions made in these summaries. Each "Tax Study" paper will present detailed arguments, with the appropriate citation of sources and references, for each of these issues. These summaries are intended only to give readers a flavor of the arguments about each issue. For those readers who wish to examine some of the sources on which these summaries draw, see the listing, "Selected Readings in Taxation and Higher Education," attached as part of this initial installment of A Guide to Tax Policy and Higher Education, in particular, the papers by Feldstein, Boskin, Clotfelter, Taylor, Mansfield, Groves, and Myers from Research Papers Sponsored by the Commission on Private Philanthropy and Public Needs, and the papers by Andrews, Bittker and Levi.

Deduction, Not a Credit

Some people have urged that an income tax credit be given for charitable contributions instead of the deduction. A tax credit is a direct reduction in taxes; a tax deduction is a reduction in income liable to taxation. For instance, if a tax credit of 30 percent of the value of a taxpayer's gifts to charity were substituted for the charitable deduction, and if a taxpayer gave \$100 to charity during the year, he would be able to subtract \$30 from his taxes, rather than to subtract \$100 from his income.

The effect of a credit versus a deduction on an individual taxpayer can be illustrated by looking at the above example. Under a 30 percent credit, every taxpayer giving \$100 saves \$30 in taxes (assuming each taxpayer's tax bill is at least \$30; if some owe less, then the credit will be only good for the actual amount of taxes owed). Under a deduction, a taxpayer giving \$100 also saves \$30 in taxes if he is in the 30 percent tax bracket. If his tax bracket is higher than 30 percent, he will save more than the \$30 in taxes for making the \$100 gift. If his tax bracket is lower than 30 percent, he will save less than \$30 in taxes for making the \$100 gift.

There are four problems with an income tax credit instead of a deduction for charitable giving. First, there are good reasons to argue that the deduction is theoretically correct, that a deduction for charitable giving is essential to the proper measurement of net income, which, under the dominant theory of personal income taxation, is the best approximation of the ability-to-pay. Net income is comprised of the new consumption plus new saving (including the net increase in the market value of property owned by the taxpayer) during the relevant taxing period. But charitable giving represents the voluntary transfer of private resources to public use. It is neither a form of personal con-

sumption nor personal savings. Therefore, it must be deducted in order to determine true net income, the measure of one's ability-to-pay, that is, to consume or save out of current receipts or out of the net increase in market value in property owned by the taxpayer.

Second, the net effect of substituting for the charitable deduction a credit ranging from 20 to 30 percent, the range most often discussed in public debate, would be to increase total charitable contributions, but to decrease giving to education, museums, and hospitals. A credit much lower than 20 percent would tend to decrease giving to all charities; a credit of approximately 50 percent would increase both total giving and giving to education, cultural organizations and hospitals, but the revenue loss to government would be extraordinarily high.

Third, the 20 to 30 percent tax credit approach, when compared to the charitable deduction, would have the "upside-down-effect" of increasing personal disposable or "take-home" (after-tax, after-gift) income the more, the higher one's tax bracket.

Finally, the tax credit may well run afoul of the principle of separation of church and state, and be ruled unconstitutional with respect to religious organizations and charities.

Thus, the tax credit approach is theoretically questionable, and its practical consequences make it unacceptable.

Deduction Without Floor

Under current law, a taxpayer does not have to give a minimum amount to charity before he is allowed to take a charitable deduction. That is, the first dollar of charitable contributions is currently deductible by each taxpayer who itemizes his personal deductions.

Some persons have proposed allowing the deductibility of charitable gifts only to the extent that contributions exceed some minimum, called a qualifying "floor". This qualifying "floor" might be a flat dollar amount, such as \$100, or a percentage of adjusted gross income, such as 3 percent. This proposal would treat charitable giving much as medical expenses under current law, deductible only if quite large in relation to one's income.

This proposal is inadequate on both theoretical and practical grounds. First, a deduction for charitable giving is arguably necessary to define income properly. Allowing the deduction only to the extent gifts were in excess of some qualifying "floor" would mean taxing the person making the gift on more income than that amount which theoretically measures his ability-to-pay. All charitable gifts should in theory be fully deductible from gross income.

Second, there is already in the law a percentage of income limitation on the maximum amount of charitable giving a taxpayer can deduct in any year. While, in theory, if the charitable deduction is "income-defining", there should be no such maximum limitation, it does serve to

ensure that no taxpayer, solely because of his voluntary gifts to the public good, is entirely freed of some duty to pay some mandatory taxes for the same public good as well. While this limitation, even though a departure from the implications of tax theory, may be justified by considerations of political theory, there is no such justification for departing from tax theory by the adoption of a minimum or qualifying "floor" for the charitable deduction as well.

Third, it fails on practical grounds. Based on 1970 data, econometric studies estimate that a 3 percent floor would cut total giving by 20 percent and education gifts by 36 percent; a \$100 threshold would reduce total giving and reduce that to education by approximately 5 percent. New Treasury Department revenue would fall markedly short of the dollars lost to charity. Thus, a qualifying "floor" would serve only to reduce the number of private dollars voluntarily directed by individuals to the support of public purposes.

Fourth, it runs counter to the efforts of the Congress and the Administration to try and simplify the income tax system. A qualifying "floor" for the charitable deduction would unnecessarily complicate the tax law.

Finally, the "floor" proposal is advanced most often as an aid to the tax audit process by the Internal Revenue Service, as a mechanical means to reduce error and fraud in the claiming of deductions. The U.S. Treasury Department and the IRS argue that it would especially be necessary if the charitable deduction were made available to every taxpayer, whether filing the long form (1040) or the short form (1040A) and whether or not itemizing personal deductions.

But the audit problem is exaggerated. The IRS would, in effect, try to reduce audit problems by discouraging charitable giving, and in a way that not only would reduce substantially gifts to charity, but would reduce such gifts by more than it would boost tax revenues. Thus, at the substantial cost of net resources (taxes plus charitable gifts) devoted to public concerns, the IRS would try to control some error and fraud of minor significance, if any at all, hardly a cost effective approach. If there are audit problems at all, there are better ways of solving them than the use of qualifying "floor" that would severely depress total charitable giving in our society.

Deduction for All Taxpayers: "Above-the-Line"

Under current tax law, only those taxpayers who file the long income tax return (Form 1040), and itemize personal deductions are allowed to deduct their charitable contributions. Persons filing the short return (1040A) or not itemizing personal deduction but instead using the standard deduction (now called the "zero tax bracket amount") cannot take the deduction.

Each taxpayer should be able to take the charitable deduction, whether or not he itemizes personal deductions, and whether he files the long form or the short form, because charitable gifts represent the voluntary trans-

fer of private resources to public use. The purpose of taxation is to shift private resources available for personal consumption or saving to public uses. Charitable gifts should not be taxed, since they represent neither personal consumption nor personal savings, the measure of net income which is the basis of income taxation, but rather result in the voluntary shift of private resources to public uses. Only by allowing every taxpayer to take the charitable deduction can this objective be attained.

Such a change in the tax law would, according to econometric studies based on 1970 data, increase total charitable giving by 7 percent and would yield \$1.19 of new charitable giving for every \$1.00 of revenue lost by the Federal Treasury. It would also enhance the universality of participation by giving proper recognition to the public character of private philanthropy by all taxpayers. Currently, only 25 percent of all taxpayers itemize deductions. Less than ten years ago, 50 percent did so. This percentage would shrink to 15 percent under some tax proposals now pending before Congress. Finally, extending the charitable deduction to all taxpayers would underscore the uniqueness of private giving as the keystone of this nation's pluralistic society, and the uniqueness of the charitable deduction as the one provision in the tax code that allows a deduction for sharing one's income with the whole community instead of spending it on oneself.

Full Fair Market Value Deductibility of Charitable Gifts of Appreciated Property

Under current tax law, persons making charitable gifts of certain kinds of property are able to take the full fair market value of that property as a charitable deduction up to a ceiling of 30 percent of their adjusted gross income. It is called appreciated property. Such property, if sold, would give rise to capital gains income, and has appreciated in value. This means that its current market value is greater than the value of the property at the time it was acquired by the taxpayer, the difference in value being called appreciation.

There are two threats to this provision of tax law that is of great benefit to charitable giving. One is direct; the other indirect.

Some people have proposed directly eliminating the full fair market value deductibility for charitable gifts of appreciated property, limiting the deduction to original cost (with appropriate adjustments if any) or to original cost plus 50 percent of appreciation, on grounds of tax theory. They argue that not only is there the value of the deduction, but that the value of the appreciation never is included in the giver's gross income. Thus, they conclude, the donor receives two benefits: tax savings from the charitable deduction itself, and savings from the permanent exclusion of the net appreciation from his income.

Indirectly, full fair market value deductibility might be eliminated if the current tax treatment of long term capital gains were eliminated. This would depend on how carefully such a provision were drafted. Ac-

cordingly, if legislation were adopted to tax capital gains income as ordinary income, an amendment might be necessary to preserve the full fair market value deductibility for charitable gifts of appreciated, or capital gains, property.

There are several arguments for preserving this treatment of such charitable gifts:

First, the U.S. income tax system currently does not tax appreciation until property is sold or exchanged for something else of value. But a person giving away property to charity is not selling it or exchanging it for personal value; rather he is donating it for the use and benefit of the public. Such a gift should not be treated as giving rise to income. Moreover, this would be consistent with the way in which noncharitable gifts of appreciated property are treated in tax law. Such gifts do not give rise to income for the donor. Rather the recipient takes the donor's cost of the gift as his cost for purposes of determining net appreciation in the event of his future sale or exchange of the property. When the recipient sells, he then pays any tax due on the appreciation. Gifts to charity are treated in the same way; the cost is carried over to the charity ("carry-over" basis) and tax liability is triggered upon sale or exchange by the charity. But there is never any tax due because Congress has declared that charities are to be taxed at a zero bracket rate.

Second, as a practical matter, the elimination or substantial narrowing of the fair market value deductibility of gifts of appreciated property would cost charities, according to econometric studies based on 1970 data, as much as \$1.33 in gifts for every new dollar of revenue gained by the Treasury. This loss would strike hard at every charity, especially in the areas of general fund campaign leadership gifts and of capital gifts.

Third, if the law were changed, many taxpayers would simply hold onto their property. They would not sell, exchange or give it away. As a result, there would be substantial losses in charitable giving, little new tax revenue, and continued deferral of taxation with respect to the appreciation in the property. Moreover, with respect to the contingent liability associated with the property that continues to be held by the taxpayer, that is, the capital gains tax being deferred on the value of the appreciation in the property, the present discounted value of that contingent tax cost to the taxpayer diminishes almost to zero the longer the taxpayer plans and is able to hold onto the property in question. And, of course, the wealthier a taxpayer is, the longer in general, he will be able to plan and actually hold onto property. Thus, only the public beneficiaries of the charitable services would lose out.

At the same time, the higher one's income, the more personal income would be available to taxpayers, compared with present law, if the law were changed. Such a change would also mean fewer voluntary transfers, during lifetime of the donors, of wealth from private hands to public uses through charitable activity. Thus, the full fair market value deductibility for gifts of appreciated property actually increases the total flow of resources (taxes plus charitable gifts) to public purposes and increases the rate at which property and wealth are dispersed throughout or for the

use of society during the lifetimes of any group of taxpayers, and in a manner consistent with the pluralistic character of American society.

Minimum Tax

Under current law there is in addition to the regular individual income tax a minimum tax on tax preference income. The purpose of this tax is to ensure that every taxpayer, especially those with high gross incomes, but low adjusted gross incomes or low taxable incomes because of eligibility for a variety of exclusions, exemptions and deductions available in the tax code, pays a minimum amount in income taxes. Certain exclusions or deductions or exemptions are called under this law "tax preferences". The value of these are added up and are called the minimum tax base. Then, certain deductions are allowed from this minimum tax base, and a tax of 15 percent is assessed against what remains.

This minimum tax was created in 1969, largely in response to Treasury studies showing that several hundred millionaires and other high income persons were paying little or nothing in federal income taxes. Because of certain allowable deductions from the minimum tax base, in 1976, the minimum tax was still not accomplishing its purpose. Thus, in the 1976 Tax Reform Act there was placed a new provision, a new item of tax preference income, described as the sum of itemized personal deductions in excess of 60 percent of adjusted gross income. The practical effect of this new item for inclusion in the minimum tax base is that no taxpayer reporting any gross income at all will be able to avoid paying some income tax.

There are many ways in which the minimum tax can affect the charitable deduction. The 1976 amendment, creating the new item of "tax preference income" -- itemized personal deductions in excess of 60 percent of adjusted gross income -- included charitable giving within its scope, but careful econometric studies showed that it would have no effect in the aggregate or with respect to broad classes of charitable organizations on the levels of charitable giving. Nonetheless, it does have an effect on charitable giving by some individuals.

Other ways in which the charitable deduction might be affected in the aggregate by changes in the minimum tax include such proposals as making the appreciated part of gifts of appreciated property an item of "tax preference income", lowering the percentage in the "tax preference" item "deductions in excess of 60 percent of adjusted gross income" to 50 percent or less, increasing the minimum tax rate, and changing the allowable deductions from the minimum tax base.

The goal for the charitable community concerning the minimum tax is to test the specifics in any minimum tax measure to measure the impact on giving and to devise alternatives to offset any harm to giving threatened by such changes. Getting charitable giving out of the minimum tax altogether by moving the deduction "above-the-line" and making it available to every taxpayer as a proper "income-defining" deduction would be of significant benefit with respect to the minimum tax as well as with respect to the regular income tax.

Exclusion of Appreciated Property Gifts from Taxation of Gains at Death

The individual income tax does not tax the year-to-year gains in the market value of property held by a taxpayer. Under current law, there is no income taxation at death, either, on the net gains in value accumulated in property since the time of its acquisition. The property goes into the estate and is valued at current fair market value. Then an estate tax is levied on this amount after appropriate adjustments. What is left passes to the heirs and other recipients of bequests. The value of the property at the time of original acquisition, adjusted for estate taxes paid and for other appropriate costs, is "carried-over" under the new law enacted in 1976 to the heirs or other recipients for their own tax purposes.

Some people have proposed an income tax at death on the value of the appreciation in the property in the estate. Such an income tax on unrealized capital gains at death would have a dramatically adverse impact on bequests of appreciated property unless charitable gifts were specifically exempted from such a tax. This income tax would be in addition to the estate tax.

The practical effect of such a tax would be to force the sale of much of the property and a payment of a substantial income tax to the government. This would leave much less in the estate to be given to the charities listed in the decedent's will, or to any other heirs or recipients of bequests. This would wreck havoc on the estate tax marital deduction as well, and an exemption here would be necessary lest the value of property left for the widow/widower plummet. Thus, even if the unlimited 100 percent estate tax charitable deduction were maintained, the effect of such an income tax on gains at death would leave fewer resources in the estate to be given to charity.

Some tax experts have proposed a flat rate, additional estate tax (AET) as an alternative to the proposed income tax on capital gains at death. The AET would impose a flat rate tax on the total value of the appreciation of all property in the estate. This would be in addition to the usual estate tax. Just as in the case of the proposed income tax on capital gains at death, bequests to charity should be excluded from AET.

Bequests are a major source of endowment funds, and typically some in the form of appreciated property. As with life-time appreciated property gifts, preservation of the full deductibility of bequests of appreciated property in any income tax system must be maintained.

Unlimited Estate Tax Charitable Deduction

Current tax law allows an unlimited 100 percent estate tax charitable deduction. Proponents of limiting this deduction to 50 percent of the value of the estate rely on two arguments: (1) to make tax treatment of the federal estate tax charitable deduction consistent with that of the federal individual income tax charitable deduction; and (2) to increase revenue from the federal estate tax.

The first argument fails to distinguish the legislative purpose of the estate tax from that of the income tax. The legislative purpose of the estate tax is to limit excessive intergenerational transfers of wealth within each family. The 100 percent unlimited estate tax charitable deduction serves this fundamental purpose of estate taxation very well by encouraging people during life and at death to give their property to charitable organizations which carry out public purposes and serve public needs.

A 1975 econometric study by Professor Michael Boskin of Stanford University shows that a 50 percent limitation on the estate tax charitable deduction would cost charity \$4.40 in gifts for every \$1.00 of revenues gained. This \$3.30 difference for every \$1.00 of revenues gained would pass on to the heirs of the decedents, thus increasing, relative to existing law, the intergenerational transfers of wealth within individual families. Thus, the proposed change would directly conflict with the fundamental purpose of the federal estate tax.

Second, the Boskin study also reveals that the proposed change would only increase estate tax revenues by tens of millions of dollars, not by the hundreds of millions predicted by proponents of this change. At the same time, gifts to charity would decline by \$4.40 for every \$1.00 of new revenue. This would result in a severe decline in the total resources, raised through the combination of the estate tax and of the estate tax charitable deduction, available to serve public needs.

The current law should be retained unchanged. The 100 percent unlimited estate tax charitable deduction is a powerful and fair mechanism for shifting substantial resources from private use and consumption to public use and benefit through bequests to charitable organizations.

Exclusion of Scholarships

Scholarships and fellowships (to a limited extent) are excluded by statute from taxation. But there are constant battles with the Internal Revenue Service (IRS) over the eligibility of various public and private awards or forms of financial assistance to students and scholars for this tax treatment. Examples of recent types of awards challenged by the IRS include tuition remission programs, loan forgiveness features of certain student loan programs, and various federal scholarships containing mandatory service or pay-back provisions, such as the National Research Service Awards.

The Staff of the Joint Committee on Taxation of the U.S. Congress, at the direction of the House Committee on Ways and Means and the Senate Committee on Finance, is currently conducting a study of the tax treatment of fellowships, scholarships, and employer-sponsored employee educational or training programs. The higher education community has a major stake in the outcome of this study.

SELECTED READINGS IN
TAXATION AND HIGHER EDUCATION

American Association of Fund Raising Counsel, Inc., GIVING USA, 1977 Annual Report. New York: 1977.

Andrews, William D., "A Consumption-Type or Cash Flow Personal Income Tax," 87 Harvard Law Review 1113 (1974).

Andrews, William D., "Personal Deductions in an Ideal Income Tax," 86 Harvard Law Review 309 (1972).

Association of American Universities, Tax Reform and the Crisis of Financing Higher Education. Washington: Association of American Universities, 1973.

Association of the Bar of the City of New York, "Proposal for Limitation on the Use of Tax Incentives," A Report by the Committee on Taxation. New York: 1976.

Bittker, Boris I. and C. Galvin, R. Musgrave and J. Pechman, A Comprehensive Income Tax Base? A Debate. (1968)

Bittker, Boris I., "Charitable Contributions: Tax Deductions or Matching Grants," 28 Tax Law Review 37 (1972).

Break, George F. and Pechman, Joseph A., Federal Tax Reform: The Impossible Dream? Washington: The Brookings Institution, 1975.

Coalition for the Public Good, The Charitable Deduction: Its Role in Preserving a Viable Public-Private Relationship. Alexandria, Virginia: 1975.

Commission on Private Philanthropy and Public Needs (The Filer Commission), Giving in America: Toward a Stronger Voluntary Sector. Washington: Department of the Treasury, 1975.

1/30/78

Commission on Private Philanthropy and Public Needs (The Filer Commission) Research Papers Sponsored by the Commission on Private Philanthropy and Public Needs (Five Volumes), Washington: Department of the Treasury, 1977. (Hereinafter, abbreviated Filer)

Michael J. Boskin and Martin S. Feldstein, "Effects of the Charitable Deduction on Contributions by Low-Income and Middle-Income Households: Evidence from the National Survey of Philanthropy," 3 Filer 1441, (1975).

Michael J. Boskin, "Estate Taxation and Charitable Bequests," 3 Filer 1453, (1975).

Cheit, Earl and Theodore Lobman III, "Private Philanthropy and Higher Education: History, Current Impact and Public Policy Considerations," 2 Filer 453, (1975).

Commentary on Commission Recommendations; Donee Group Report. 1 Filer 3.

Martin S. Feldstein, "Charitable Bequests, Estate Taxation, and Intergenerational Wealth Transfers," 3 Filer 1485, (1975).

Martin S. Feldstein and Charles Clotfelter, "Tax Incentives and Charitable Contributions in the United States: A Micro-economic Analysis," 3 Filer 1393, (1975).

Martin S. Feldstein and Amy Taylor, "The Income Tax and Charitable Contributions: Estimates and Simulations with the Treasury Tax Files," 3 Filer 1419, (1975).

Jenny, Haus H. and Mary Allen, "Philanthropy in Higher Education: Its Magnitude, Its Nature and Its Influence on College and University Finance," 2 Filer 515, (1975).

Mansfield, Harry K. and Ronald Groves, "Legal Aspects of Charitable Contributions of Appreciated Property to Public Charities," 4 Filer 2251, (1975).

Myers, John Holt, "Estate Tax Deduction for Charitable Benefits: Proposed Limitations," 4 Filer 2299, (1975).

Council for Financial Aid to Education, Voluntarism, Tax Reform, and Higher Education. New York: Council for Financial Aid to Education, 1975.

Council for Financial Aid to Education, Voluntary Support of Education, 1975-76. New York: 1977.

Covey, Richard B., "Possible Changes in the Basic Rule for Property Transferred by Gift or a Death," Taxes-The Tax Magazine 831 (1972).

Davies, John H., "The Charitable Contributions Credit: A Proposal to Replace Section 501 (c)(3) Tax-Exempt Organizations," 58 Cornell Law Review 304 (1973).

Department of the Treasury, Blueprints for Basic Tax Reform. Washington: 1977.

Goode, Richard, The Individual Income Tax. Revised Edition. Washington: The Brookings Institution, 1976.

Kennedy, Senator Edward M., "Compendium of Papers on Federal Tax Reform," Congressional Record S-11591 (daily ed. July 2, 1976).

Levi, Julian H., "Financing Education and the Effect of the Tax Laws," in Law and Contemporary Problems: Federal Taxation and Charitable Organizations, Vol. XXXIX, No. 4. Durham, North Carolina: Duke University Press, Autumn 1975.

Levi, Julian H. and Sheldon Steinbach, Patterns of Giving to Higher Education III: An Analysis of Voluntary Support of American Colleges and Universities 1973-74. Washington, D.C.: American Council on Education, 1975.

McDaniel, Paul, "Alternatives to Utilization of the Federal Income Tax System to Meet Social Problems," 11 Boston College Industrial and Commercial Law Review 867 (1970).

McLure, Charles E. Jr., "Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals," 88 Harvard Law Review 532 (1975).

Pechman, Joseph A. (ed.), Comprehensive Income Taxation. Washington: The Brookings Institution, 1977.

Peterson, George E. (ed.), Property Tax Reform. Washington: John C. Lincoln Institute and Urban Institute, 1973.

Staff of the House Committee on Ways and Means, 94th Congress, 2nd Session, "Background Materials on Federal Estate and Gift Taxation." Washington: 1976.

Stern, Emil, Jr., "Federal and State Tax Policies," in Public Policies and Private Higher Education, edited by David M. Breneman and Chester Finn, Jr. Washington, D.C.: The Brookings Institution, to be released in April 1978.

1/30/78

Surrey, Stanley S., "Federal Income Tax Reforms: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Government Assistance," 84 Harvard Law Review 352 (1970).

Surrey, Stanley, "Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures," 83 Harvard Law Review 705 (1970).

Surrey, Stanley, Pathways to Tax Reform. Cambridge, Massachusetts: Harvard University Press, 1973.

Surrey, Stanley, "The Federal Tax Legislative Process." 31 Record of the Association of the Bar of the City of New York 509 (1976).